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INTERNAL REVENUE SERVICE'S 1988 REPORT ON THE "TAX GAP"

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

MARCH 17, 1988

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INTERNAL REVENUE SERVICE'S 1988 REPORT ON THE "TAX GAP"

THURSDAY, MARCH 17, 1988

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
WEDNESDAY, MARCH 9, 1988

PRESS RELEASE #15
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
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THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON THE INTERNAL REVENUE SERVICE'S 1988 REPORT ON THE "TAX GAP"

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will conduct a hearing on the Internal Revenue Service's (IRS) 1988 report on income tax compliance and the estimated "tax gap." The hearing is scheduled for Thursday, March 17, 1988, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m. The Subcommitee will receive testimony from IRS Commissioner Lawrence B. Gibbs, Jr.

The "tax gap" is an estimate of the difference between the amount of taxes voluntarily paid in a taxable year and the amount of taxes that would have been paid if all taxpayers had filed complete and accurate returns. The "tax gap" results primarily from individual and corporate noncompliance which includes the failure to file returns, report income, calculate deductions properly, and pay taxes correctly and on time.

In announcing the hearing, Subcommittee Chairman Pickle stated: "Previous studies have estimated that the 'tax gap' ranges anywhere from $75 to $100 billion. I look forward to the IRS providing the Subcommittee with some hard facts and figures as a result of their soon-to-be-released study. Also, I am interested in information on how the so-called 'underground economy' fits into the larger issue of taxpayer compliance."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons wishing to submit written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, April 8, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. We will ask the subcommittee to please come to order and ask our guests to have a seat, if you will.

Good morning, Commissioner and the top of the morning to you here on March 17. We are glad to have you here.

The Subcommittee on Oversight will take testimony today to discuss the Internal Revenue Service's most recent estimate of tax noncompliance and the tax gap.

Commissioner Gibbs will share with this committee the IRS tax gap estimates and projections from 1973 to 1992. The Commissioner's statement will be updated, and an analysis of the tax gap since their studies on this subject in 1979 and 1983.

The Internal Revenue Service will report today that the gross income tax gap for tax year 1987 is approximately $85 billion. This is alarmingly high, and I understand it is projected to increase in the future. Furthermore, the Internal Revenue tax gap does not include noncompliance estimates for tax areas outside of income tax.

We have lots of listening and questioning to do today, and I know we look forward to this hearing because it is an important one for this committee and for the American people.

Now, according to the IRS's definition, tax gap is an estimate of the difference between amount of taxes voluntarily paid in the taxable year and the amount of taxes that would have been paid if all taxpayers had filed complete and accurate returns. The tax gap consists of both unpaid individual and business income taxes and exists because some taxpayers underestimate income, overstate deductions, credits and exemptions, and math errors on their tax returns.

The tax gap also consists of taxes due on tax returns not filed. To some extent, the tax gap includes overlaps with what the press and the public refers to as the underground economy.

The goal and focus of today's hearing is to determine whether the tax gap has increased or decreased, to discuss why the size of the tax gap has changed, to better understand the components of the tax gap, to explore what an incredibly large tax gap means in terms of our voluntary tax compliance system and the administration of the tax laws, and of course, to examine the extent to which the tax gap can be reduced for future years.

Well, this is a challenging and important list of questions. The Internal Revenue Service is not receiving or collecting all taxes due the U.S. Government. This is a very serious matter and one about which every citizen undoubtedly is concerned.

Commissioner, we are going to be pleased to hear your testimony and hope we get a lot of good, valuable and helpful information as we proceed.

Now, let me ask my colleague Dick Schulze if he has any opening statement to make.

Mr. SCHULZE. Thank you, Mr. Chairman.

I join you in welcoming the Commissioner to the hearing. The term "tax gap" has no precise definition. It has evolved as a figure of speech in recent years. In general, the tax gap refers to the difference between what taxpayers actually owe in Federal income taxes and what they voluntarily pay. It seems to me 8 to 10 years ago the buzz word in Washington was "underground economy," and perhaps the new buzz word is "tax gap".

The failure of individuals and businesses to pay their lawful income tax has several effects. First, it increases the burden on law abiding taxpayers to pick up the slack. Honest taxpayers wind up paying more than they otherwise would have to pay. The situation is similar to the retail store which must raise the cost of goods sold to all shoppers in order to cover the losses from shoplifters.

Second, the tax gap aggravates the Federal deficit. The unpaid taxes make the deficit larger than it should be. Each dollar in unpaid taxes increases the deficit by a dollar. The result is that the Government must then borrow those amounts from investors. This increases the interest cost of the Government.

Today the subcommittee should be able to develop a better understanding of what the tax gap is. Our objective should be to identify the various elements which contribute to the total tax gap picture. Once we have identified the major elements of the tax gap, we will be in a better position to consider steps to reduce it.

The recent Tax Reform Act was hailed as a positive step in improving taxpayer compliance. The reduction in the number of deductions was designed in part to reduce the opportunity for taxpayers to manipulate and overstate their deductions. Also, the improvement in the information reporting system should reduce the opportunity for persons to underreport their investment income. Thus, one net effect of tax reform should be to improve the compliance rate in years ahead.

Mr. Chairman, we should be sensitive to one element in the campaign to reduce the tax gap, and I refer to increased IRS enforcement activities. While increased enforcement may increase tax collections, there may be a point of diminishing returns. This is because increased enforcement may alienate the vast majority of taxpayers who make an honest effort to report accurately.

First, there is a question of how far the IRS should intrude into a person's everyday life in the name of tax enforcement. This involved the image of big brother always looking over our shoulders.

Second, when the IRS makes a mistake, it can make life miserable for some innocent taxpayer. An increase in IRS enforcement activity regrettably may bring with it an increase in mistaken enforcement actions. For example, the person whose business was almost ruined by a wrongful IRS levy on his bank account illustrates the situations which are fueling support for a strong taxpayer bill of rights.

Mr. Chairman, I look forward to learning more about the tax gap issue. By identifying the elements which make up the tax gap, we will be better equipped to help the Commission take reasonable steps to address the problem.

Thank you.

Chairman PICKLE. Commissioner, before we start the hearing this morning, I would like to express my condolences to you and to the people at IRS and to the family and friends of Mr. Frank Malanga who passed away this weekend. He was the Director of the Research Division, and as I understand it, did a lot of work in the preparation of this tax gap report that we are going to be examining here. I understand further that he was highly regarded at the IRS Center, and so to you and to the IRS, we do express our condolences on his loss.

Now, Commissioner, if you will proceed with your testimony, we will be anxious to hear what you have to report to us.

STATEMENT OF HON. LAWRENCE B. GIBBS, JR., COMMISSIONER, U.S. INTERNAL REVENUE SERVICE, ACCOMPANIED BY JOHN L. WEDICK, JR., DEPUTY COMMISSIONER FOR PLANNING AND RESOURCES

Commissioner GIBBS. Thank you, Mr. Chairman. I am delighted to be here this morning to discuss with you and the other members of the subcommittee our study of tax gap estimates which we recently concluded.

With me here today is our Deputy Commissioner for Planning and Resources, John Wedick.

I will have a short oral statement to make which will follow the written testimony. I will keep you posted as to where I am in the written testimony. At the conclusion of my statement, Mr. Wedick and I will be happy to answer any questions you may have. I ask that the complete written testimony be submitted for the record.

Chairman PICKLE. Without objection, it will be done.

Commissioner GIBBS. In 1983 the Internal Revenue Service estimated that the gross income tax gap for 1987 would be $115 billion. This was the last tax gap study that we did.

Since that time, several major tax bills, including the Tax Reform Act of 1986, have made significant changes which have helped to reduce the tax gap and improve compliance by individual taxpayers. In addition, we have developed new data to be used in measuring the tax gap, and we have improved our methods of estimating the tax gap. Based on our most recent analysis, we now estimate that the gross income tax gap for 1987 will be approximately $85 billion.

We also project an improved rate of voluntary compliance for individual taxpayers through 1992. However, because of economic expansion and inflation, we estimate the size of the tax gap to grow to nearly $114 billion by 1992.

So this morning, Mr. Chairman, I guess we could say that we have good news and we have bad news. The good news is that the tax gap we believe has shrunk by some $30 billion over what we had previously estimated. The bad news is that it is still at very, very substantial levels.

Turning to page 2 of my testimony, as I indicate there, I will define the tax gap, discuss its major components and explain why our tax gap estimates today are lower than those published in 1983.

Before continuing, however, I would like to make two points. First, our estimates of the tax gap are just that, estimates. They are developed with a high degree of professionalism and with the best data that we have available, but by their very nature, they are subject to greater variation than most estimates. This is particularly true in estimating the corporate tax gap because we have limited data in the corporate area on which to base our estimates.

Accordingly, the tax gap for corporations is subject to more uncertainty than is the case for individuals. In computing our corporate tax gap estimates we have assumed that the recent tax law

changes will have no effect on the corporation's voluntary compliance rate, either up or down. Accordingly, we have applied an average 82½ percent compliance rate against an increasing corporate tax base to arrive at the projected increases in the corporate tax gap.

There are alternative methods, perhaps, that could be used to compute the corporate tax gap, but the methodology we have used is consistent with the manner that we have computed the corporate tax gap in the past.

The second point that I would like to make is that our estimates are measures of noncompliance, but they are not measures of the potential for additional enforcement yield.

Now on page 3.

The tax gap has three components. First, amounts which will eventually be collected through our current enforcement activities. The second element is amounts that are not collected through current enforcement activities but could be collected if we had the resources to do so and could be collected on a cost effective basis. And the third component of the tax gap involves amounts which are not collected through current enforcement activities and would not be cost effective to collect regardless of the amount of resources the Internal Revenue Service had.

Congress and the administration may wish to continue to look at the data on enforcement program yields in the federal budget process. I want to stress that you cannot take the tax gap and project from it the amount of revenue that the Internal Revenue Service could collect.

Chairman PICKLE. Well, Commissioner, you say there is no relation between the tax gap and the amount you could collect? I do not understand that.

Commissioner GIBBS. No, no, sir, I did not say that, Mr. Chairman.

Chairman PICKLE. Well, you are saying we cannot hope to collect it.

Commissioner GIBBS. No, sir. I said there are three parts to the gross income tax gap of $85 billion. The first part is the amount of the tax gap that we actually collect with our present enforcement resources. The second part of the tax gap are amounts that we could collect if we had additional resources. But there is a third component of the tax gap. Regardless of how many resources you give us, there is a point at which it is no longer cost effective for us to collect the tax gap, that is simply because it would cost more to collect it than what we would actually collect. This is the third component of that gross tax gap.

And that is the only point I am making.

Chairman PICKLE. I am not trying to say that you have a tax gap of that much, you have got to go get it. It is not that simple. I accept that. But if you have a study and you in your own testimony say that the tax gap is $85 billion—and I think that is underestimating it—then you have to use that as the base of your hopes, at least, you could get as much of that as possible.

But to say that you just cannot say you have got a tax gap and then we are going to collect it is not acceptable to me.

I think we understand each other. I just did not want to take lightly the fact that you make this study and then indicate that it really does not mean very much.

Commissioner GIBBS. I will be happy to explore it further. I do have some suggestions as to how we can diminish the tax gap, but I do not want to leave the impression that by simply spending more money we will automatically be able to collect all of the tax gap.

Chairman PICKLE. We accept that.

Commissioner GIBBS. I would like to turn to page 4 and deal a bit with the definition of tax gap because I think it is important to pin down exactly what it is we are talking about when we use the term "tax gap."

In the report we define the gross tax gap as the amount of income tax owed but not voluntarily paid. To elaborate on this rather simple definition, I would like to make several points.

First, the tax gap is concerned only with income taxes, both individual and corporate income taxes. Other types of taxes such as employment and excise taxes are not included in the tax gap.

Second, the word "voluntarily" means without IRS enforcement action. Through enforcement we do assess and collect part of what taxpayers owe but do not voluntarily pay, and thus close a part of the gross tax gap. The amount of the gap that is left after our current enforcement efforts is sometimes referred to as the net tax gap, net after our enforcement activities.

Turning to page 5, I would like to make the third and final point, namely, that our estimates account for noncompliance in the regular economy and also the legal sector of the underground economy such as unreported income from sidewalk vendors. It does not include income from the illegal segment of the underground economy, narcotics, organized crime, prostitution, those types of things. That is not included in our tax gap estimates.

Turning to page 6, with respect to the 1987 gross tax gap, we estimate that it consists of $63½ billion for individuals and approximately $21.4 billion for corporations. Individuals who do not file the tax returns that they are required to file account for about $7.2 billion of the tax gap, while individual filers, those who actually file returns, account for over $56 billion.

The tax gap for individual filers is due to unreported income or overstated subtractions from income, that is to say, overstated itemized deductions, adjustments, or exemptions. The tax gap for individual filers also includes math errors on returns.

By far the largest part of the tax gap, some $48.3 billion, or about 57 percent, relates to individual taxpayers who file returns but who understate their income. $16.6 billion of understated income is attributable to understated, nonfarm business income of self-employed individuals while some $7.7 billion is unreported by informal suppliers who tend to operate off the books, such as sidewalk vendors, moonlighting mechanics, folks who tend to operate in a very informal manner are examples of the so-called informal suppliers.

Turning to page 8, total tax gap in current dollars increased from $28 billion in 1973 to $95 billion in 1986. We estimate that the tax gap falls to $85 billion in 1987, but then is projected to rise to $114 billion by 1992. Overall, the provisions to improve compliance

contained in recent legislation have slowed the rate of growth of the tax gap. Taken together, these changes repealed or limited many deductions from taxable income and thereby minimized the opportunity for taxpayers to overstate the income tax effects of these itemized deductions.

In addition, tax reform lowered marginal rates, thus reducing the tax gap associated with unreported income. In the future, economic expansion and growth will cause the size of the gross tax gap to grow to, as I mentioned, about $114 billion in 1992. Despite this growth in the size of the tax gap, we estimate that voluntary compliance rates will improve for individuals.

For 1987, we estimate the compliance rate for individuals to be 83½ percent, and it is expected to rise to 84.9 percent by 1992.

I would now like to turn to page 9 of the testimony dealing with comparisons of this estimate with prior IRS estimates. As I indicated, in 1983 we estimated the gross income tax gap for 1987 to be about $115 billion. Today, as I also indicated, we estimate the 1987 tax gap to be about $85 billion, a decrease of approximately $30 billion.

There are several reasons, we feel, why this tax gap estimate has been reduced.

The effects of tax reform decreased the previous estimate of the individual tax gap by $14 billion. After 1986, the corporate tax gap was actually increased as a result of recent legislation by $6.8 billion. On the individual side, tax reform broadened the base for individuals by eliminating, restricting or phasing out a number of subtractions from income, such as itemized deductions, credits and exemptions.

To the extent a deduction or credit is no longer allowed, a taxpayer cannot overstate it. Also, because tax reform lowered individual rates, it reduces the tax associated with unreported income. If the unreported income stays the same and the rate goes down, then there is less of a tax gap.

On the corporate side, the tax gap has grown because of increased corporate tax liabilities due to economic growth and base broadening, and also because we assume stable rates of voluntary compliance, as we have done in the past. Again, we made this assumption concerning stable corporate compliance rates because we have no experience to guide us in predicting what the effects will be of large changes in the tax law for corporations.

Turning to page 10, the new data that we are using in our tax gap estimates that we are releasing today have become available since 1983. This accounts for a decrease of some $8.8 billion compared to our previous estimates.

The previous tax gap estimates were based largely on compliance data, on individuals, for 1976 and earlier years, and corporation examinations closed in 1980. The revised estimates incorporate compliance data on individuals for tax years 1979 and 1982. For large corporations, the revised estimates are based on examinations that were closed as recently as 1986.

Turning to page 11, I would like to comment that in addition to new data, improvements in our estimation methods have lowered the tax gap by some $6.8 billion.

Finally, individual income tax estimates in the 1983 report contained estimates for the so-called remittance gap which are taxes reported but not submitted with the tax return. These prior estimates were inaccurate, so our revised estimates have excluded this factor until we can develop a more accurate measure on which we are working.

Omission of the remittance gap accounts for roughly $7 billion of the difference between our 1983 estimate and our current estimate.

Turning to page 12 and concluding, despite the magnitude of the tax gap, I would like to emphasize that most taxpayers are honest, and our tax system is basically sound. The tax that is reported voluntarily, that is to say, without any IRS enforcement effort, is over 83 percent of what is owed. High levels of voluntary compliance result from a sound tax administration system based on withholding and information reporting, and a perspective of fairness that has been bolstered, I think, by recent legislation.

The Tax Reform Act of 1986 has done much to restore the confidence in our nation's tax system. We at IRS will ensure that promise of fairness through a balanced approach of providing quality service to American taxpayers who are attempting to comply with their tax obligations, and ensuring strong compliance efforts with our tax laws for those who do not wish to comply.

Mr. Chairman, before answering any questions that you might have, I would like to take just a moment, as you did, to honor the memory of Frank Malanga, for many years the Director of our Internal Revenue Service Research Division. Frank passed away unexpectedly this past weekend. It was under Frank's direction and guidance that the estimates of the tax gap that we are discussing today were developed. We at the Internal Revenue Service will miss him both as an esteemed colleague and as a good friend, but I have a sneaking suspicion that Frank is going to be watching us today, and his spirit will certainly be here as we discuss the tax gap report that he had such a strong hand in producing.

Mr. Chairman, that concludes our testimony, and Mr. Wedick and I will be happy to answer any questions that you and the subcommittee members may have.

[The prepared statement and attachment of Commissioner Gibbs follow:]

STATEMENT OF

LAWRENCE B. GIBBS

COMMISSIONER OF INTERNAL REVENUE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss with you our latest estimates of the size, scope and composition of the tax gap. With me is John Wedick, our Deputy Commissioner for Planning and Resources. We will be happy to answer any questions you might have at the conclusion of my testimony.

I. INTRODUCTION

Five years ago, the Internal Revenue Service estimated that the gross income tax gap for 1987 would be $115.2 billion. Since then, several major tax bills, including the Tax Reform Act of 1986, have made significant changes to our Nation's tax laws which have helped to reduce the tax gap and to improve compliance by individual taxpayers. Additionally, we have developed new data and improved methods relevant to our estimating process for the tax gap. Based on our analysis, we now estimate the gross income tax gap for 1987 to be $84.9 billion.

In looking towards the future, we project an improved rate of voluntary compliance by individual taxpayers through 1992. But despite that trend, economic expansion and inflation will cause the size of the tax gap to grow to nearly $114 billion in 1992. Accordingly, the Internal Revenue will need to effectively use its resources to promote voluntary compliance through not only enforcement activities, but through taxpayer service activities which are necessary to ensure the trust and confidence of taxpayers in our voluntary tax system.

My written testimony today covers three points. First, it defines the tax gap. Second, I will discuss the tax gap's major components. Finally, my testimony explains why our tax gap estimates are lower than those published in 1983.

Before continuing, however, there are several important points that I would like to make. First, our estimates of the tax gap are just that -- an estimate. Although our estimates are developed with a high degree of professionalism and with the best data available, by their very nature they are subject to greater variation than most estimates. In the case of estimating the tax gap for the corporate sector, particularly, we have much less data with which to base our estimates. Accordingly, the tax gap estimates for corporations are subject to more uncertainty than those for individuals.

In computing our corporate tax gap figures, we have assumed that recent tax law changes will have no effect either positively or negatively on the corporate voluntary compliance rate (VCR) for reporting overall tax liabilities. Accordingly, we have applied an average 82.5% voluntary compliance rate against an increasing corporate tax base to arrive at the projected increases in the corporate tax gap. This methodology is consistent with the manner in which we have computed the corporate tax gap in the past.

An alternative method of computing the corporate tax gap would be to assume constant voluntary reporting percentages (VRP's) for the elements used to calculate net corporate income (receipts, cost of goods sold, and expenses). Using this method, the corporate tax gap would not increase, but would probably decrease slightly, due primarily to the recent repeal of the investment tax credit and corporate rate reductions. We do not have the same kind of reliable voluntary reporting percentage data for the corporate elements of net income as we do in the case of individuals, which would be required to use this method.

Second, our estimates of the tax gap are measures of total noncompliance, but are not intended to be measures of the potential for additional enforcement yields. The tax gap consists of 3 components: (1) amounts which are eventually collected through current enforcement activities, (2) amounts which are not collected through current enforcement activities and would be cost effective to collect, and (3) amounts which are not collected through current enforcement activities and would not be cost effective to collect. Accordingly, the Administration and Congress should continue to look to data on specific enforcement program yields in the context of the Federal budget process.

II. TAX GAP ESTIMATES

A. DEFINITION OF GROSS TAX GAP

Gross tax gap is the amount of income tax owed but not voluntarily paid.

Since the tax gap is a measure of noncompliance which conveys significant information on the challenges faced in collecting taxes, this simple definition needs further elaboration. First, the tax gap is concerned only with income taxes; both individual and corporation. While there are significant compliance problems associated with other types of taxes, such as employment and excise, they are not included in our estimates because we do not yet have the data and methods available to measure gross tax gaps for these areas.

Second, the word "voluntarily" means without IRS enforcement action involving our Collection, Examination, and other IRS functions. IRS, through these enforcement programs, does assess and collect part of what taxpayers owe but do not voluntarily pay and, thus, ultimately closes part of the gross tax gap. Estimates of the "net tax gap" that remains after IRS enforcement actions are currently being developed.

Finally, our tax gap estimates account for noncompliance in the "regular economy" and also the legal sector of the "underground economy", such as unreported income by moonlighters or sidewalk vendors. They do not include income from the illegal segment of the underground economy which is extremely difficult to measure and to tax.

In addition to understanding what the tax gap is, it is also important to understand why it exists. The tax gap exists because some individuals and businesses:

- understate income,
- overstate deductions, credits and exemptions,
- make math errors on the tax returns they file, and
- do not file the tax returns they are required to file.

By far, the largest part of the tax gap, about 57 percent, relates to individual taxpayers who file returns, but who understate their income.

B. 1987 INDIVIDUAL GROSS TAX GAP

The individual tax gap of $63.5 billion represents 74.8 percent of the total income tax gap. It consists of a $56.3 billion tax gap for individuals who file tax returns but who underreport income, overstate subtractions (itemized deductions, adjustments and exemptions) or make math errors, and a $7.2 billion tax gap for individuals who fail to file required income tax returns.

Underreported income accounts for $48.3 billion of the individual filer tax gap with sole proprietor incomes accounting for about half of this amount. About $16.6 billion of the tax gap was due to understated nonfarm business income of self-employed individuals, while an estimated $7.7 billion was unreported by "informal suppliers" who tend to operate "off the books". Informal suppliers include roadside or sidewalk vendors, moonlighting craftsmen or mechanics, unlicensed providers of child or elderly care services, and similar operators with an informal business style.

The voluntary reporting percentage which measures the relationship between the total amounts of income or related items that are voluntarily reported and the corresponding correct amounts that should have been reported is only 13.1 percent for informal supplier income; evidence that when IRS has no information on the incomes earned and taxpayers keep poor books and records, compliance tends to be poor. However, when income is subject to withholding, compliance in reporting such income markedly improves. For example, a very large portion of wage and salary income is covered by withholding where the voluntary reporting percentage for filers is estimated to be 99.5 percent. The percentage for pensions and annuities is almost as high -- 98.4 percent. In addition, most interest and dividend income is covered by information reports resulting in an estimated voluntary reporting percentage of 94.6 percent. When information reporting is less complete, such as with capital gains, the percentage is only 88.3 percent.

C. 1987 CORPORATION GROSS TAX GAP

The corporation gross tax gap of approximately $21 billion represents about 25 percent of the total income tax gap for 1987. Large corporations with $10 million or more in assets dominate the total corporate tax gap by accounting for $15.8 billion. Small corporations account for the remaining $5.2 billion, split almost equally between underreported income and overstated deductions and credits.

D. TRENDS

The total tax gap in current dollars shows an increase from $28 billion for 1973 to $95 billion in 1986. The tax gap falls to $85 billion in 1987, but is projected to rise to $114 billion in 1992.

Overall, the provisions to improve compliance contained in the Tax Equity and Fiscal Responsibility Act of 1982, the Interest and Dividend Tax Compliance Act of 1983, the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986 have slowed the rate of growth of the tax gap. These changes in the tax law, taken together, repealed or limited many deductions from taxable income, thereby minimizing the possibility for taxpayers to overstate these income offsets. Tax Reform lowered marginal tax rates, thus reducing the tax gap associated with unreported income.

The estimated growth of the tax gap over the years is largely due to the growth of income tax liabilities through real expansion of the economy and through inflation. Therefore, the tax gap can grow rapidly even though compliance rates are changing slowly or not at all. For example, the individual tax gap grew rapidly from $19.7 billion in 1973 to $46.8 billion in 1979 while the voluntary compliance rate decreased by about three percentage points, from 84.6 percent in 1973 to 81.8 percent in 1979. The tax gap then continued to grow to $51.9 billion in 1982 even though the voluntary

compliance rate improved to 83.7 percent. In 1987, the individual voluntary compliance rate stands at 83.5 percent and is expected to increase to 84.9 percent by 1992.

III. COMPARISONS WITH PRIOR IRS ESTIMATES

The gross tax gap estimates that we are releasing today reflect a decrease of $30.3 billion over our 1983 estimates for 1987. The individual tax gap estimates have decreased by $40.5 billion while the corporation estimates have increased by $10.2 billion.

There are several reasons why the new tax gap estimates are lower than those published in 1983. These include the effect of recent tax law changes on the tax base, the availability of new compliance data, and other factors including improvements in methodology and the omission of the remittance gap in the new estimates.

A. RECENT TAX LAW CHANGES

Recent tax law changes have broadened the tax base by eliminating, restricting and phasing out a number of subtractions from income. To the extent that a deduction from income is no longer allowed, a taxpayer cannot overstate it on the tax return. This reduces noncompliance. In addition, because tax reform also reduced the rates at which individual incomes are taxed, it reduces the tax gap associated with unreported income. As a consequence, recent tax law changes decreased the previous individual income tax gap estimate for 1987 by $14.4 billion. The corporate tax gap estimate increased by $6.8 billion because of increased corporate tax liabilities (due to economic growth and base broadening), and because we assumed stable rates of voluntary reporting of overall corporate tax liabilities. Absent voluntary reporting percentage data for the detailed income and expense items making up corporate net income, we were not able to predict in a more sophisticated manner the specific effects of specific tax law changes on corporate compliance.

B. NEW DATA

The tax gap estimates being released today were also affected by new data that became available since the 1983 IRS report on the tax gap was published. The previous IRS tax gap estimates were based largely on compliance data on individuals for 1976 and earlier years and corporation examinations closed in 1980. The revised estimates incorporate compliance data on individuals for tax years 1979 and 1982. For large corporations, the revised compliance estimates are based on examinations closed as recently as 1986. In addition, the revised estimates include data from a 1985 household survey that provided information on informal suppliers working "off the books" and from other special studies.

The revisions resulting from these new data sources lowered the 1987 estimate of the individual gap by $8.4 billion, while lowering the corporate tax gap by $0.4 billion.

C. OTHER FACTORS

Improvements in our estimation methods lowered the individual tax gap estimate by $10.7 billion in 1987 while changes in our corporate estimation methods raised the corporate tax gap by $3.9 billion for 1987.

The individual income tax gap estimates in our 1983 report also contained estimates for the remittance gap which are taxes reported, but submitted without payment. Since prior estimates of the remittance gap were very inaccurate, our revised estimates exclude this measure until such time that we can develop an accurate measure. Omission of the remittance gap accounts for roughly $7.0 billion of the difference between previous and current estimates of the overall tax gap.

IV. CONCLUSION

Mr. Chairman, despite the magnitude of the tax gap, I can't emphasize too strongly that most taxpayers are conscientious, and that the tax system is basically sound and reliable. The tax reported voluntarily -- that is, without any enforcement effort -- is over 83 percent of what is owed. We should not overlook, however, the fact that this voluntary compliance results largely from a good set of tax administration rules based on withholding and information reporting, and a perspective of fairness that I believe has been bolstered by recent legislation. The Tax Reform Act of 1986 has done much to restore confidence in our Nation's tax system, and I urge the Congress not to tamper with the promise that it holds. IRS will ensure that promise of fairness through a balance between service to the public and ensuring compliance with our nation's tax laws. Our budgets in 1988 and 1989 reflect that balanced approach which I believe is essential in the long run to sound tax administration.

Department
of the
Treasury
**Internal
Revenue
Service**

Income Tax Compliance Research

Gross Tax Gap Estimates and Projections for 1973-1992

Publication 7285
March 1988

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This report contains the Internal Revenue Service's new estimates of the gross income tax gap. Earlier estimates were revised to reflect recent tax law changes, recent compliance data, and improvements in tax gap estimation methods.

For additional detail on the methods used to derive the estimates, write to: Chief, Compliance Analysis Group, Research Division (PFR:R), Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224. Alternatively, for the additional information, call: (202) 376-0720.

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Introduction

The mission of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency and fairness. To achieve this purpose, IRS must determine the extent of noncompliance with the tax law and regulations. The tax gap is a comprehensive measure of noncompliance which conveys significant information on the challenges faced in collecting taxes that are not voluntarily paid. This report presents IRS's revised estimates of the gross tax gap, which is the amount of income tax owed but not voluntarily paid. The "net tax gap" is the gross tax gap less taxes paid as a result of IRS enforcement activity.[1] In this report the words "gap" or "tax gap" always refer to the gross tax gap.

The tax gap consists of unpaid individual and business income taxes on legally earned income. The gap exists because some individuals and businesses understate income, overstate deductions, credits, and exemptions, and make math errors on the tax returns they file. It exists also because some do not file the tax returns they are required to file, and because some do not voluntarily pay taxes they report. (This report, however, does not contain estimates for taxes reported but not paid.) The tax gap estimates presented in this report do not include gaps resulting from failure to report employment or excise taxes, or any tax other than the Federal income tax.

IRS has revised the tax gap estimates for 1987 and forward in order to reflect effects of recent tax legislation on individual and corporation income tax liabilities, the availability of more recent data, and improvements in estimating methods. The estimates are projected forward to 1992. Chapter I presents the tax gap estimates in detail for 1987 and analyzes trends and projections through 1992. Chapter II compares the new with the old estimates and discusses the reasons why the new estimates are lower than those published in 1983. (The previous IRS tax gap estimates appeared in *Income Tax Compliance Research: Estimates for 1973-1981*, published in July 1983.) Chapter III describes the methods used in making the estimates.

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[1] IRS annually collects over $20 billion of income tax through enforcement programs. Estimates of the net tax gap are currently being developed for publication in a later report. The report should be available in the summer of 1988.

Chapter I

The Estimates

IRS estimates the gross income tax gap for tax year (TY) 1987 to be $84.9 billion. This consists of a $63.5 billion gap for individuals and a $21.4 billion corporate gap. This chapter explains what these gap estimates measure, discusses individual and corporate noncompliance in 1987, and sets the 1987 tax gap in the context of preceding years and projections through 1992.

A. Definitions

The income tax gap is the amount of income tax owed for a given year, but not voluntarily paid. The word "voluntarily" means without actual enforcement action, such as examination, collection, or criminal investigation. These estimates do not correspond directly to any figures in the budget of the Federal Government. IRS, through enforcement programs, does assess and collect part of what taxpayers owe but do not voluntarily pay and, thus, closes part of the tax gap. The tax gap estimates in this report do not net out this enforcement revenue, however; nor do they include penalties and interest, which Federal budget receipts include. Although the estimates prepared for this report are sometimes called gross tax gap measures, they are net of tax which is voluntarily overreported.

The unreported income estimates should not be equated with income earned in the so-called "underground economy." Press reports and scholarly works have defined the underground economy in various ways. In particular, it is not clear which types of business activities should be included. Such ambiguities make this "economy" more a figure of speech than an operational concept that can be measured. Further, this term usually encompasses both illegal and legal transactions. Although income from illegal transactions is taxable, it is extremely difficult to measure and to tax, and is therefore not included in the estimates prepared for this report. IRS estimates, besides accounting for unreported income earned in the regular economy, also account for noncompliance in the legal portion of the underground economy, such as unreported informal supplier income and unreported tip income. (Informal suppliers include roadside or sidewalk vendors, moonlighting craftsmen or mechanics, unlicensed providers of child or elderly care services, and similar operators with informal business styles.)

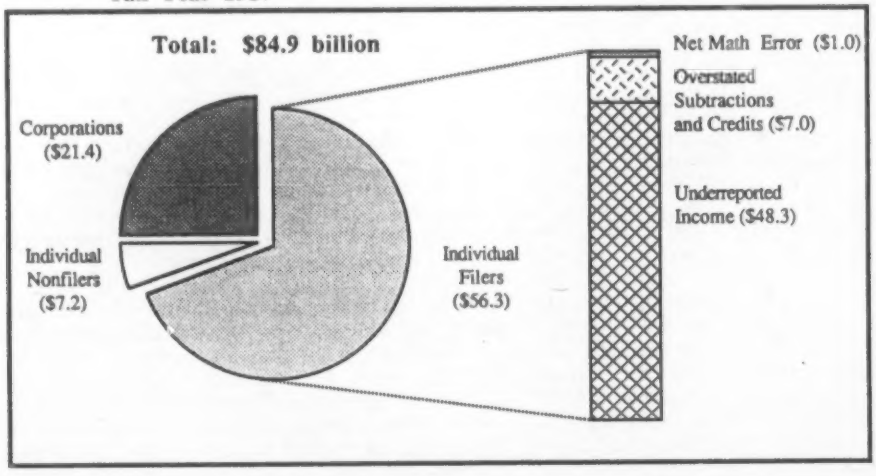
B. Noncompliance in 1987

The estimates of noncompliance in 1987 are essentially projections from earlier data. Tax year 1982 is the latest year for which we have compliance data for individual taxpayers. We based the 1987 tax gap figures on the assumption that voluntary reporting percentages (VRPs—amounts reported expressed as percentages of amounts which should have been reported) have remained at 1982 levels for each income, deduction, and credit item. (Estimated effects of the compliance provisions of the 1982, 1983, 1984 and 1986 tax acts were superimposed on this baseline.) Notwithstanding the assumption of constant VRPs, recent tax legislation will reduce the individual income tax gap by reducing the number of tax items that may be overreported and by lowering marginal tax rates.

1. Individual Gross Tax Gap for 1987

As Chart 1 and Table I-1 show, individual taxpayers who file returns but underreport their tax liabilities account for most tax dollars lost to noncompliance. For TY 1987, we estimate the filer tax gap to be $56.3 billion, which is almost eight times as large as the gap resulting from individuals who fail to file required tax returns. There are three sources of this gap: underreported income, overstated subtractions (itemized deductions, adjustments, and exemptions) and credits, and "math errors." Of the three parts, income underreported by individual filers contributes by far the largest amount to the tax gap. In 1987, this amounted to $48.3 billion. Nonfarm and farm sole proprietor incomes account for over half ($26.3 billion) of this amount.

Chart 1. Revised Estimates of the Gross Tax Gap (in billions), Tax Year 1987



In Table I-1, tax on underreported nonfarm proprietor income is divided into two major parts. First, an estimated $7.7 billion of tax on underreported proprietor income was earned by "informal suppliers" who tend to operate "off the books." Second, about $16.6 billion of the tax gap was due to understated nonfarm business income of self-employed individuals operating in more conventional ways. Tax on underreported farm proprietor income is $1.9 billion.

Table I-1 combines partnership income and small business corporation distributions to individuals.[2] Inadequate reporting of these incomes on 1987 returns contributed an estimated $3.2 billion to the tax gap. Underreported net rent and royalty income accounts for $3.1 billion. Failure to report capital gains contributed another $6.6 billion, while underreported interest and dividends accounts for $3.2 billion. The shortfall in reported tax due to underreported wages, salaries, pensions and annuities is approximately $1.5 billion.

[2] The net income of a qualified small business corporation (defined in section 1371 of the Internal Revenue Code), whether or not distributed, is taxed as ordinary income through each stockholder. Therefore, it is quite similar to partnership income for tax purposes.

Table I-1. Distribution of the Gross Income Tax Gap by Source, Tax Year 1987

Source of Gap	Tax Gap ($ millions)		Percentage Distributions of the Tax Gap	
Total Income Tax		**84,874**		100.0
Individual Income Tax		63,475		74.8
Filers of tax returns		56,301		66.3
Underreported income	48,292		56.9	
Wages and salaries	1,417		1.7	
Interest and dividends	3,227		3.8	
Capital gains	6,650		7.8	
Informal suppliers [1]	7,739		9.1	
Other nonfarm proprietor income	16,646		19.6	
Farm income	1,904		2.2	
Partnership and small business corporation income	3,216		3.8	
Pensions and annuities	123		0.1	
Rents and royalties	3,141		3.7	
Estate and trust income	64		0.1	
State income tax refunds	86		0.1	
Alimony income	173		0.2	
Taxable unemployment and Social Security benefits	338		0.4	
Other income	3,566		4.2	
Overstated subtractions	6,062		7.1	
Adjustments	545		0.6	
Deductions	3,478		4.1	
Exemptions	2,039		2.4	
Credits	899		1.1	
Math Errors	1,049		1.2	
Nonfilers of tax returns		7,174		8.4
Corporation Income Tax		21,399		25.2
Small corporations (assets under $10 million)		5,225		6.2
Unreported income	2,519		3.0	
Overstated deductions	2,706		3.2	
Large corporations (assets of $10 million or more)		15,845		18.7
Other [2]		329		0.4

[1] Informal suppliers are proprietors who operate with informal business styles. See page 1.

[2] Consists of $164 million gap for fiduciaries and $165 million gap for unrelated business income of tax exempt organizations.

Note: Details do not add due to rounding.

The remaining $4.2 billion is attributed to estate and trust income, underreported state income tax refunds, alimony, taxable social security and unemployment insurance payments, and other income. "Other income" consists of such items as prizes, awards, gambling profits, recovery of bad debts, insurance received as reimbursement for medical expenses incurred in a previous year, and deductions for carryovers or carrybacks of business net operating losses.

2. Corporation Gross Tax Gap for 1987

The corporation tax gap estimates shown in Table I-1 refer to filers of corporate returns. Due to lack of specific compliance data for large corporations, unreported income and overstated expenses appear as separate sources only for small corporations.

The first column of Table I-1 shows that large corporations ($10 million or more in assets), with a tax gap of $15.8 billion, dominate the total corporate tax gap of $21.4 billion. The relative sizes of the gaps largely reflect the much larger aggregate tax liability of large corporations. Small corporations (less than $10 million in assets) account for $5.2 billion of the total, split almost equally between underreported income and overstated deductions and credits.

C. Voluntary Reporting Percentages

Voluntary reporting percentages (VRPs) measure the relationships between the total amounts of income or other related items that are voluntarily reported for any given year, and the corresponding correct amounts that should have been reported for that year. The correct amounts depend on the income tax provisions of the Internal Revenue Code in effect for that year as well as such things as the strength of the economy during that year.

1. Individual VRPs for 1987

Noncompliance means reporting too little or too much tax, income, or any of the various deductions or credits that taxpayers may subtract from tax or income. Underreporting or overreporting is measured on a net basis. Ordinarily, taxpayers underreport incomes more frequently than they overreport them. Consequently, VRPs for income items are less than 100 percent. Conversely, offsets to tax or income, such as credits and exemptions, are overreported more frequently than they are underreported. Consequently, VRPs for these items generally exceed 100 percent.

Table I-2 shows estimates of how much income and offsets to income individual filers underreported or overreported in 1987, along with the corresponding VRPs. Note that these estimates do not reflect nonfiler noncompliance. Estimates of unreported nonfiler income can be misleading because tax on such incomes has frequently been fully or partially paid, principally through withholding of tax by the taxpayer's employer. Thus, for tax year 1987, although delinquent nonfiler[3] incomes totaled $158.7 billion, the nonfiler tax gap was only $7.2 billion (see Table I-1). Moreover, data on nonfilers, available only for 1972 and 1977, are much less conclusive than data on filers, whose returns are scientifically sampled and thoroughly examined.

[3] We distinguish delinquent nonfilers from legitimate nonfilers who are not required to file tax returns since their total incomes fall below the filing thresholds. Legitimate nonfilers do not contribute to the tax gap.

Table I-2. Reported and Underreported Incomes, Overstated Items and Voluntary Reporting Percentages (VRPs) for Individual Tax Return Filers, Tax Year 1987

	Amount Reported ($ millions)	Amount Under/ Overreported ($ millions)	VRP [1]
Total Income of Filers	2,750,292	247,734	91.7
Wages and salaries	2,051,093	9,427	99.5
Interest and dividends	229,078	13,153	94.6
Capital gains	191,002	25,261	88.3
Informal suppliers [2]	7,740	51,417	13.1
Other nonfarm proprietor income	89,330	86,018	—
Farm proprietor income	-11,313	11,289	—
Partnership and small business corporation income	10,607	14,589	—
Pensions and annuities	125,589	2,103	98.4
Rents and royalties	67	15,715	—
Estate and trust income	15,138	285	98.2
State income tax refunds	9,287	463	95.2
Alimony income	3,341	1,362	71.0
Taxable unemployment	16,113	1,965	89.1
Taxable Social Security benefits	10,785	364	96.7
Other income [3]	2,435	14,323	—
Total Subtraction Items	867,345	36,522	104.4
Adjustments	36,686	2,186	106.3
Deductions	390,189	16,555	104.4
Exemptions	440,470	17,781	104.2
Taxable Income of Filers	2,078,015 [4]	284,254	88.0

[1] Five VRPs are not shown because they would be distorted by the combination of positive and negative amounts of income. The VRPs that are shown would have been lower if the unreported incomes of nonfilers had been included.

[2] Informal suppliers are proprietors who operate with informal business styles. See page 1.

[3] Includes deductions for carryovers and carrybacks of business net operating losses.

[4] Reported taxable income exceeds total reported income less subtractions because, for returns with subtractions greater than income, taxable income is zero.

In tax administration, it is axiomatic that when third parties report to the tax agency the income they pay to individuals, compliance in reporting such income markedly improves. Withholding tax at the source has proven to be an even more effective means of assuring compliance. Due to the variety of circumstances under which income is earned and paid in a modern economy, one cannot precisely quantify the impacts of information reporting or withholding on compliance. Nevertheless, the VRPs in Table I-2 reflect the positive influence of withholding and information reporting on compliance.

For example, a very large portion of wage and salary income is covered by withholding, and we estimate the VRP for wages and salaries to be 99.5 percent for filers. The VRP for pensions and annuities is almost as high—98.4 percent. Although withholding is optional to the taxpayer, pensions and annuities are almost universally covered by

information reporting. At the other extreme, when IRS has no information on the incomes earned and taxpayers keep poor books and records, compliance tends to be very low. For example, we estimate the VRP for informal supplier income to be only 13.1 percent.

Most interest and dividend income is covered by information reports. However, substantial amounts of interest and dividends, particularly when received from abroad, are not subject to information reporting. Information reporting for capital gains is less complete than for interest and dividends. For example, brokers' reports to IRS are limited to information on the sale of their clients' publicly traded securities. Reflecting the more limited information IRS receives from third parties, the estimated filer VRPs for interest and dividends and capital gains are 94.6 percent and 88.3 percent, respectively.

Notice that Table I-2 does not present VRPs for some income categories. When a particular income type can be negative as well as positive, the VRP may become inaccurate. Moreover, negative values included in the aggregate for an income type will distort VRPs even if the aggregate in question is positive.

2. Corporation VRPs for 1987

VRPs cannot be calculated for large corporation income and deduction items because specific data on what should have been reported are not available. (Taxpayer Compliance Measurement Program [TCMP] studies have not been conducted for large corporations.) In the case of small corporations, for which TCMP studies are available, the VRPs for 1987 are 97.3 percent for total income reported (after expansion for unreported income not detected in TCMP—see page 15) and 101.4 percent for deductions reported.

D. Trends

Knowledge of income tax compliance patterns for a given year is vital for effective tax administration. However, compliance trends also provide important information. These

Chart 2. Estimates of the Gross Tax Gap by Major Component, Selected Tax Years, 1973-1992

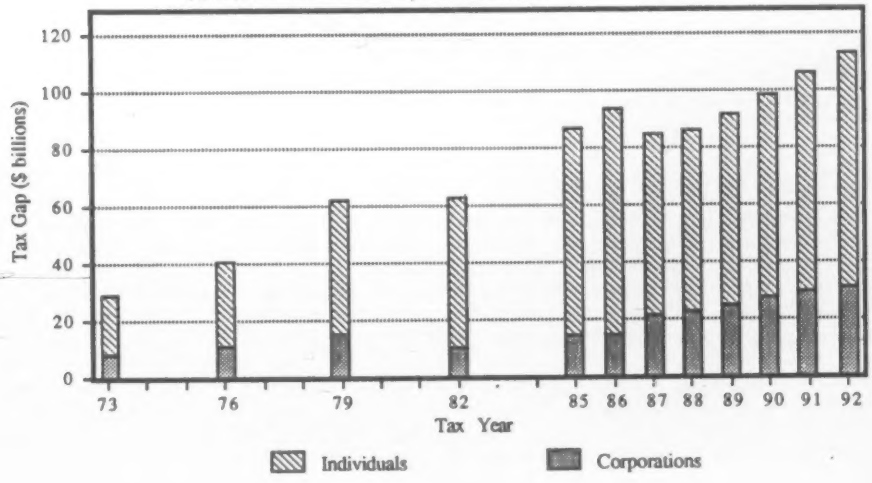


Table I-3. Gross Tax Gaps and Voluntary Compliance Rates, Selected Tax Years, 1973-1992

	1973	1976	1979	1982	1985	1986	1987	1988	1992
Tax Gap[1] ($ billions)									
Total	28.4	40.7	61.7	62.6	87.8	95.0	84.9	87.1	113.7
Individuals	19.7	29.6	46.8	51.9	73.3	79.3	63.5	64.3	82.6
Filers	17.9	26.8	42.3	46.2	65.5	71.2	56.3	56.9	72.4
Understated income	15.4	24.6	36.4	38.1	54.6	60.0	48.3	48.5	62.8
Overstated deductions	2.4	2.0	4.7	6.5	8.6	8.9	6.0	6.1	6.8
Overstated credits	-0.1	-0.3	0.6	0.9	1.2	1.3	0.9	1.1	1.3
Math errors	0.2	0.2	0.5	0.7	1.0	1.0	1.0	1.1	1.5
Nonfilers	1.8	2.8	4.5	5.7	7.8	8.1	7.2	7.3	10.2
Corporations[2]	8.8	11.1	15.0	10.7	14.4	15.6	21.4[3]	22.8	31.1
Voluntary Compliance Rate (percent)									
Total	83.7	82.4	81.7	83.4	81.6	81.1	83.2	83.6	84.2
Individuals	84.6	82.6	81.8	83.7	81.6	81.0	83.5	84.0	84.9
Corporations[2]	81.3	81.6	81.3	81.8	81.7	81.7	82.5	82.4	82.5

Source: See text.

[1] Alternate estimates, based on tax that would be assessed after all appeals, are shown below. See page 8.

	1973	1976	1979	1982	1985	1986	1987	1988	1992
Gross Tax Gaps (in $ billions)									
Total	23.7	34.2	52.0	53.9	75.5	81.1	71.2	72.8	95.0
Individuals	17.5	26.3	41.4	46.3	64.8	70.1	56.1	56.8	73.1
Corporations[2]	6.2	7.8	10.6	7.6	10.7	11.0	15.1	16.0	21.9
Voluntary Compliance Rates (in percent)									
Total	86.0	84.8	84.1	85.3	83.8	83.4	85.6	85.9	86.6
Individuals	86.1	84.3	83.6	85.2	83.4	82.9	85.1	85.6	86.4
Corporations[2]	85.9	86.2	86.0	86.3	85.8	86.4	87.0	86.9	87.1

[2] Includes the tax gaps for fiduciaries and unrelated business income tax of tax-exempt organizations.

[3] The increase in the corporate tax gap from an estimated $15.6 billion in 1986 to an estimated $21.4 billion in 1987 is attributable to the increase in corporate tax liabilities due to tax law changes enacted in 1986 and to the increase in corporate profits.

trends are illustrated in Chart 2 below, and are detailed in Table I-3. The estimates of the total tax gap in current dollars show an increase from $28 billion for 1973 to $62 billion for 1979 and to $85 billion for 1987. The gap is projected to increase to $114 billion for 1992.

The estimated growth of the tax gap is due in large part to the growth of income tax liabilities through real expansion of the economy and through inflation. The growth rate also reflects changes in the voluntary compliance rate (VCR), which for each year is the total amount of tax voluntarily reported as a percent of total tax liability. For example, the

individual gap grew rapidly from 1973 to 1979, but from 1979 to 1982 it grew at a much slower rate. This change in the growth rate reflects corresponding changes in the VCR for individuals, which decreased from 84.6 percent in 1973 to 81.8 percent in 1979, and increased back to 83.7 percent in 1982. The most recent year for which TCMP data exist for individuals is 1982. For years after TY 1982, IRS assumed that the VRP for each source of individual income (e.g., sole proprietor income or wage income) and for each deduction item remained constant.

Some types of income, such as proprietor income, are not reported as completely as other types. Consequently, when the relative importance of the more poorly-reported types increases in response to changing economic conditions, the VCR for individual income tax declines. Thus, the individual VCR declined from 83.7 percent in 1982, a recession year, to 81.6 percent in 1985, a year of expansion. The combined influence of a period of prosperity, which enlarged the tax base, and the decline in the VCR accelerated the growth rate of the individual tax gap from 1982 through 1985.

The tax gap estimates themselves, however, were lowered for years after 1982 to account for the expected impact of all recent tax law changes designed to improve compliance. The drop in the individual tax gap from $79.3 billion in 1986 to $63.5 billion in 1987 is primarily due to the reduction of individual income tax liabilities enacted in 1986. This legislation lowered marginal tax rates, but it also repealed or limited many deductions from taxable income, thereby minimizing the possibility for taxpayers to overstate these income offsets.

Corporate compliance data over time are quite limited. Consequently, in estimating and projecting the total corporate tax gap, essentially one composite VCR was used to represent corporate compliance for all years. The decline in the corporate gap from an estimated $15.0 billion in 1979 to an estimated $10.7 billion in 1982 does not reflect VCR changes, but rather the drop in corporate tax liabilities over that period due to the two back-to-back recessions of 1980 and 1981-1982 plus tax cuts enacted in 1981. The increase in the corporate tax gap from an estimated $15.6 billion in 1986 to an estimated $21.4 billion in 1987 is attributable to the increase in corporate tax liabilities enacted in 1986 and to the increase in corporate profits. The VCR for all corporations in TY 1987 was approximately 82.5 percent.

The primary estimates for individual filers and corporations depend on the results of audits of tax returns. The recommendations of the IRS examiners are the basis for our estimates of tax liabilities, and of tax gaps. Taxpayers are, of course, provided the opportunity to contest the recommendations of IRS examiners. In some cases, the appeals processes reverse the examiners' recommendations in part or altogether. In these cases, the amount of additional tax *assessed* is smaller than the amount *recommended* by the examiners.

Our alternate estimates, shown in a footnote to Table I-3, reflect the difference between the amounts recommended and assessed. The adjustments are based on data from the Audit Information Retrieval System (AIRS), which tracks aggregate recommendations of tax change, including recommendations made on TCMP examinations, through assessments of additional tax. This system does not state the issues (underreported income vs. overstated subtractions) on which recommendations were reduced. Thus, the alternate estimates are not available by source, and the aggregate alternate estimates cannot be derived precisely from the primary estimates. Furthermore, in using the AIRS data, we were not able to account for the following considerations: (1) in some cases, IRS appeals officers settle for less than the full liabilities to avoid the hazards and costs of litigation; (2) taxpayers whose audits did not reveal deductions, business expenses, exemptions, or adjustments which they had overstated on their returns do not appeal; (3) taxpayers who disagree with their examiners' recommendations for small increases in tax may not appeal.

Chapter II

Comparisons With Prior IRS Estimates

The previous IRS tax gap estimates, published in 1983, were based largely on compliance data on individuals for 1976 and earlier years. For large corporations, the most recent compliance data used were from examinations closed in 1980; for small corporations, the most recent data came from a TCMP study of firms with accounting periods centered around tax year 1977. The revised estimates incorporate compliance data on individuals derived from TCMP examinations of returns filed for TYs 1979 and 1982. The revised compliance estimates for corporations are based on examinations closed as recently as 1986. This report also incorporates data from a 1985 household survey that provided information on informal suppliers working "off the books," and from other special studies.

In addition to these new data, significant improvements in estimation methods and changes in the tax laws have contributed to making the old estimates out of date. The estimates in this report, therefore, replace those published in 1983. Our analysis of the differences will focus on tax year 1987 as well as on 1981, since the latter was the last tax year for which the 1983 report contained detailed estimates.

Table II-1 highlights the four principal reasons why the new tax gap estimates are lower than those published in 1983. These are: effects of recent tax legislation on individual and corporate tax liabilities, the availability of new compliance and other data, improvements in methodology, and the omission of a remittance gap in the new estimates.

A. Shift of Tax Liabilities from Individuals to Corporations

In 1986, the tax base was broadened by legislation that eliminated, restricted, and phased out a number of subtractions from individual income. To the extent that, under new law, a subtraction from income is no longer allowed, a taxpayer cannot overstate it on the tax return. This reduces noncompliance. Moreover, because rates at which individual incomes are taxed were reduced, the tax gap associated with any given amount of unreported income fell. (However, because the 60-percent deduction for capital gains income was repealed, the capital gains tax gap increases.) As a consequence, recent legislation decreased the individual income tax gap estimate for 1987 by $14.4 billion. This measures the direct impact of the new law on the individual tax gap resulting from tax base broadening and lowered marginal tax rates. No attempt was made to estimate the more subtle effects this comprehensive tax legislation may have on individual attitudes and reporting behavior.

Despite a cut in the top tax rate from 46 percent to 34 percent, corporate tax liabilities increased. Therefore, our estimate of the corporate tax gap has been increased.

B. New Data

Both the 1981 and 1987 tax gap estimates of this report were affected by new data that became available since the 1983 IRS report on the tax gap was published. New TCMP data for tax year 1982 showed that filers of individual tax returns had not underreported their incomes by as much as had been projected from earlier data. On the other hand, a new and

Table II-1. Differences Between Old and New Gross Tax Gap Estimates for Tax Years 1981 and 1987 by Reason for Change (in $ billions)

	Total	Individuals	Corporations
		1987	
Old estimate of legal sector tax gap[1]	115.2	104.0	11.2
Legislative changes in tax liability	-7.6	-14.4	+6.8[2]
New data	- 8.8	- 8.4	- 0.4
Improved methods	- 6.8	- 10.7	+3.9
Omission of remittance gap in the new estimate	- 7.0	- 7.0	—
New estimate of legal sector tax gap[3]	84.9	63.5	21.4
		1981	
Old estimate of legal sector tax gap[1]	81.5	75.3	6.2
New data	+0.7	- 4.3	+5.0
Improved methods	- 8.5	- 10.7	+2.2
Omission of remittance gap in the new estimate	- 6.8	- 6.8	—
New estimate of legal sector tax gap[3]	66.9	53.6	13.3

[1] For the prior report, an additional partial tax gap estimate of $9.0 billion was prepared for the illegal sector. The illegal sector tax gap was not estimated for this report.

[2] Predicting the impact of recent legislation on corporation compliance is difficult. We have no studies, and little experience, to guide us in judging the effects of a major change in tax law. Therefore, we assumed that the corporate voluntary compliance rates (VCRs) for tax liability will remain constant. The estimated tax gap rises because of the increases in corporate tax liabilities. An alternative method would assume constant voluntary reporting percentages (VRPs) for the elements used to calculate net corporate income (receipts, cost of goods sold, expenses). With this method, the effect would be to leave the corporate tax gap estimate unchanged or to reduce it. This result would imply that VCRs would rise.

[3] The estimates of the legal sector tax gaps are on a recommended basis; that is, they include some taxes that would be recommended, but which would not be assessed on appeal. The gross tax gap estimates on an assessed basis are (in $ billions):

	1981	1987
Total	57.0	71.2
Individuals	47.6	56.1
Corporations	9.4	15.1

Note: Details do not add due to rounding.

more elaborate IRS-sponsored survey of expenditures in the informal economy for 1985 indicated that the comparable survey for 1981 had understated informal supplier incomes. The scope of the previous study had omitted significant transaction categories, including informal sales to businesses. New IRS-sponsored studies of tipping practices for various periods from 1979 to 1985, together with another IRS study of tips reported on Forms 941 before and after the

new tip information reporting requirements mandated by TEFRA, led to reductions of the estimate of tip-related tax gap. An IRS study of unreported capital gains for 1979 also led to further reductions of the individual tax gap. For individuals, the combined impact of all these new data sources was to lower the estimates of the individual gap by $4.3 billion for 1981 and by $8.4 billion for 1987.

For corporations, the major new data were from TCMP examinations of small corporation tax returns essentially for 1980, new Statistics of Income (SOI) data, revised Treasury projections of corporation tax liabilities, and operational examination results for FY 1984, 1985, and 1986. These taken together raised the corporation tax gap estimate by $5.0 billion for 1981 and reduced it by $0.4 billion for 1987.

C. Improved Methods

For the individual tax gap, improvements in methods include new procedures for expanding TCMP data to estimate the unreported income that was not detected in TCMP audits, case-by-case imputation of the additional unreported income not detected in TCMP examinations to the TCMP data files for calculating the additional tax due, and a new analysis of nonfiler data files (exact-match data) to estimate the nonfiler tax gap. These improvements lowered the individual tax gap estimate for 1981 by $10.7 billion, and, by coincidence, the corresponding estimate for 1987 also by $10.7 billion.

For the corporation estimates, new methods include the use of "yield curves" to estimate tax gap not detected in operational examinations for corporations with assets between $10 million and $100 million, and expansion of TCMP-detected unreported income for corporations with less than $10 million in assets. These changes in tax gap estimation methods raised the corporation tax gap estimate for 1981 by $2.2 billion and the corresponding estimate for 1987 by $3.9 billion.

D. Remittance Gap

The individual income tax gap estimated for the earlier report had two components: the tax liability reporting gap and the tax remittance gap. The latter, in turn, consisted of two component gaps. These were the sum of reported tax balances due which were not remitted when individuals filed their tax returns, and the sum of employer underpayments of tax they withheld from the wages of their employees. The remittance gap estimates of the previous IRS report were not sufficiently accurate. Hopefully, we shall succeed in correcting this situation in the near future. In the meantime, however, our revised estimates of the tax gap exclude measures of the remittance gap. Table II-1 shows that the omission of the remittance gap in the new estimates lowered the 1981 tax gap estimate by $6.8 billion and the 1987 tax gap estimate by $7.0 billion.

Chapter III

Methodology

Tax noncompliance occurs either when a taxpayer does not file an obligatory return or when a taxpayer files a return that does not accurately report the tax obligation incurred. (Taxpayers may also fail to pay tax they report as due; estimates of this "remittance gap" are not included in this report.) Because these two forms of noncompliant behavior are quite distinct, different sources of data and different estimation methods are necessary to determine the resulting tax loss to the government.

To estimate the noncompliance of filers, we examine a representative sample of the returns that are filed to see whether the tax due has been accurately reported. Examiners, however, cannot always find the incomes that are not reported on returns, particularly if these incomes are earned "off the books." Consequently, special compliance studies and surveys must supplement data from the examination of tax returns adequately to measure some components of the tax gap. In the case of individual nonfilers, we work with a public-use computer file of survey data from a representative sample of the general population. Through exact matching of tax return records with the survey data, we estimate the aggregate income of individual taxpayers who had not filed the required tax returns.

A. Filers of Individual Returns

The estimates of underreported income and overstated items of filers of tax returns presented in this report are grounded in thorough IRS examinations of a representative sample of such returns. These examinations are conducted every three years under IRS's Taxpayer Compliance Measurement Program (TCMP). The TCMP surveys of individuals are probability samples of approximately 50,000 tax returns. With appropriate "weighting," the TCMP data give us estimates of the aggregate error on each tax return line item that would be found if all returns were examined.

Surveys based on examinations generally disclose overstated deductible items on tax returns considerably better than they disclose understated income. This is because, to disallow deductions, the examiner need only note the lack of adequate justification or proof for them. To recommend assessment of tax on unreported income, however, the examiner must locate evidence that the unreported income has in fact been received. Since it is obviously more difficult to do the latter, the underreported incomes disclosed on TCMP examinations are not adequate measures of the actual income tax noncompliance of filers.

A study of TY 1976 TCMP cases estimated the degree to which unreported incomes covered by information returns (Forms W-2 or 1099, for example) were not disclosed on TCMP examinations. This study provided a factual basis for raising the TCMP-derived estimates to more accurate levels. Underreported incomes from all sources were not expanded uniformly by the same multiplier. Cases in which underreporting occurred because taxpayers made specific claims relating to the income that can be rebutted by an examiner were distinguished from cases involving underreported receipts or other hidden incomes that do not necessarily come to an examiner's attention during the course of an audit. The former cases, in contrast, cover (overstated) offsets to business income or other items that an examiner would normally not miss in auditing a taxpayer's return or books and

records. For example, taxpayers may understate royalty income by overstating their depletion allowances, which examiners would readily discern. Another example is the case of underreported capital gains income. This may occur because taxpayers overstate the basis, understate the sales proceeds, miscalculate the gain, or fail to report the sale of an asset. On a TCMP audit, in the absence of information returns from third parties, the failure to report the sale of an asset may never surface. However, in the case of a reported transaction, the auditor normally will have access to information to determine whether the reported capital gain has been understated due to overstating the basis or due to calculation errors. In these instances, there is no need to expand with the aid of a multiplier the unreported income to reflect more accurate levels. Special studies were conducted to help determine what proportions of various types of underreported incomes (such as capital gains, royalties, dividends, and other income) should be expanded and what proportions should not.

For every type of income, however, the expansion of the underreported income was done in the aggregate first. Then, the expanded underreported totals from each income source were imputed to different records in the IRS research data base with the aid of a computerized microdata tax model. This procedure made it possible to apply appropriate marginal tax rates to the underreported incomes from various sources.

Data from special IRS-sponsored surveys were used for tip income and net receipts of informal suppliers. The data on tips (relating to various periods from 1979 to 1985) and on informal suppliers (relating mainly to years 1981 and 1985) were extrapolated to the years for which TCMP studies were conducted and imputed by the microdata model to individual records for purposes of calculating tax gaps.

TCMP data from tax years 1973, 1976, 1979, and 1982 provide the basis for IRS individual tax gap estimates. Data from SOI provided a basis for extending the compliance estimates through 1985—the last year for which SOI data are available.

We projected the tax gap and related compliance measures beyond 1985 in four steps. First, we projected to 1992 voluntarily-reported income, deductions, and taxes paid under pre-1986 law. We did this by combining forecasts from the Office of Management and Budget and Wharton Econometrics. Second, assuming that VRPs for each tax return line item remained constant at 1982 levels, we extended the estimates of unreported incomes, overstated deductions, and underreported taxes through 1992 on the assumption that reporting for each tax return line item remained constant at the 1982 rates. Third, using a computerized microdata tax model, we adjusted the projections to reflect the impact of new tax law on each item reported. The new law lowered tax rates and made structural changes in the tax base. These affect the composition of taxable income and, at constant item-by-item compliance, the tax gap. For example, for 1987 through 1992, the proportion of gains on sales of assets rises because of the repeal of the 60-percent capital gains deduction, while the proportion of non-mortgage personal interest falls.

Finally, we adjusted the estimates and projections to reflect the estimated impacts of the compliance provisions of the Tax Acts of 1982-1984. For example, we recognized that new information-reporting requirements would raise the amount of tips, capital gains, or state tax refunds that are voluntarily reported, and that they would lower amounts overreported for interest deductions or exemptions for dependents.

B. Individual Nonfilers of Returns

The estimation started with an analysis of the public-use computer files from two studies that matched data from a national household survey with data from the Social Security Administration and IRS to estimate numbers and incomes of nonfilers of tax returns. For calendar years 1972 and 1977, about 40,000 households were randomly selected, forming a nationwide probability sample. Thus, the individuals and families surveyed were representative of the entire U.S. population regardless of whether they had received a Social Security card or whether they had filed a tax return with IRS. Individual records were linked by identifiers—mainly Social Security numbers—to generate statistical information on nonfilers and their incomes from various sources. The data for the two different years were adjusted to make them comparable and appropriate for use in estimating the nonfiler tax gap.

After the tax-related incomes of the nonfiler households were estimated, the records of low-income households who would not be required to file were dropped. Next, the tax consequences of the remaining households' failing to report their incomes were estimated. This was done by calculating the tax liabilities implied by the nonfiler incomes earned with the use of the data base mentioned above. Estimates of withholding and prepayment were based on SOI figures for the same years. These were subtracted from the tax liability estimates to obtain the tax gap estimates. Projections for other years were prepared by relating data on nonfilers to the projections for comparable filers for corresponding years.

C. Corporations

Different methods were used to derive the tax gaps for small corporations and for large corporations. For small corporations, TCMP survey data were available for estimating the tax gap. For large corporations, operational examination data were used since TCMP data were not available.

1. Small Corporations

The definition and method of estimating the tax gap for small corporations (those with assets under $10 million) are similar to those used for individuals. Both start with TCMP data for basic compliance rate information on a recommended basis and both convert this to an assessed basis to develop an alternative estimate of the final tax gap. Both also use SOI as the basis for projecting the TCMP results.

For years for which SOI tax data do not exist, projections for small corporations were based on projections of total corporate tax liability made by the Office of Tax Analysis (OTA) of the Treasury Department. Compliance rates for small corporations were based on TCMP studies done mainly for tax years 1977 and 1980. For years after 1980, the compliance rate was assumed to remain constant. We also recognized that it is not possible to detect all of the underreported income of small business entities. Unreported incomes disclosed on TCMP audits of small corporations were expanded in a manner similar to the expansion procedures used for individuals.

To compute the tax gap on the expanded amount of unreported income, a tax rate higher than the marginal tax rate from TCMP examinations was used. Under a progressive rate schedule, unreported incomes not disclosed by TCMP audits would in some instances raise the taxable incomes of smaller corporations into higher tax brackets.

For 1987 and later years, IRS adjusted the estimates to account for the recent tax law changes. The portion of the tax gap attributable to unreported income which TCMP does not detect was *reduced* to allow for the reduction in marginal tax rates. The portion of the gap attributed to the TCMP estimate of understated tax was *increased* to allow for the net increase in corporate income taxes on account of the rate reductions, base broadening, and accounting rules. For this purpose, IRS used OTA's estimates of the increases in tax liabilities of corporations due to the new tax law.

2. Large Corporations

As stated earlier, no TCMP exists for large corporations (those with assets of $10 million or more). Consequently, we used data from regular examinations—either actual or augmented with the aid of yield curves—to calculate the tax gap for large corporations. Tax reported by these corporations was obtained from SOI and from OTA projections.

For corporations with assets of over $100 million, tax increases resulting from actual examinations were used to calculate the tax gap. Although audit coverage for these large corporations is about 86 percent, effective coverage may be close to 100 percent since relatively little tax deficiency is thought to exist for the returns not examined.

For corporations with assets of between $10 million and $50 million and between $50 million and $100 million, IRS has estimated yield curves that show the average expected audit yields at all levels of audit coverage. The estimates of audit yield at 100 percent audit coverage were used to calculate the tax gap for corporations in these size classes.

For all large corporation classes, we used audit results or yield curves for the three most recent years to estimate the compliance rate for reporting of tax liability. The averaging eliminates the year-to-year variations due to administrative factors. The compliance rates were computed separately for each of three audit classes defined in terms of total assets: $10 million to $50 million; $50 million to $100 million; and $100 million and over. The compliance rates were then applied to SOI estimates of reported tax liabilities for each of the years 1973 through 1984, and to OTA estimates and projections for 1986 through 1992. For 1987-1992, the OTA projections included the expected additional reported tax liabilities arising from enacted legislation. Since the principal reason for the increase in corporate tax liabilities is the repeal of the investment tax credit, our assumption of a constant compliance rate for reporting of tax liability implies a falling voluntary reporting percentage for reporting of net income. We have no studies, and little experience, to guide us in judging the effects of such a major change in tax law. Therefore, the estimates are particularly subject to uncertainty.

For small corporations, we increased the TCMP-based tax gap estimates to reflect unreported income not detected on examination. Since incomplete detection of unreported income also occurs in operational examinations of large corporations, tax gap estimates for large corporations may be understated.

3. "Other" Tax Gap

The "other" income tax gap estimate, which is included with the corporation gap shown in Table I-1, is composed of tax gap estimates for fiduciaries (the retained income of trusts and estates) and for tax on the unrelated business income of tax-exempt organizations (UBIT). The tax gap estimate for each of these two components is based on a TCMP study. The resulting compliance rate in each case was applied to SOI and OTA estimates or projections of tax liability for all years 1973 through 1992 to generate a tax gap estimate for each year.

Chairman PICKLE. I thank the Commissioner, and again, we share with you our regrets about your loss of Mr. Malanga.

We have talked with individuals at the IRS, and they did hold him in high esteem.

Now, Commissioner, let me make one or two observations as we proceed this morning, because we have got a lot of questions to ask.

I believe, and I think all of our Members of Congress believe that we have a great tax system that is probably the model for the world as a voluntary compliance system, and we have to protect that system. I think people do voluntarily pay their taxes because they conscientiously want to pay what they owe.

But I think an individual who pays his tax wants to feel that everybody else is paying his or her fair share, and if we do not protect the taxpayer who is paying taxes, we are going to destroy the system because they feel like they are going to be played for suckers. And we have to keep that premise in mind. We cannot let people get off the hook who are not paying, because that is going to destroy our system.

That is why we must emphasize this tax gap estimate and who is not paying their taxes.

Now, I have listened to your testimony, and I accept your figures that we have about an $85 billion tax gap resulting from individuals and corporations. I also note that you say the tax gap is based on income taxes, and you do not bring in a lot of other factors that could make that even larger.

So it seems to me, Commissioner, just putting it broadly, there is a tax gap in your tax gap. You give us one estimate, but that does not include illegal source income, that does not include employment taxes, it does not include excise taxes and perhaps taxes on a few other sources of income.

If we were to add all those together, we would have $85 billion, and if you added the underground economy, accounts receivable, which is about $55 billion, you would have a $140 billion tax gap.

Now, you are concentrating only on the income aspect as you have said in your statement. We understand that. But in the very broader sense, there is a tax gap in your own tax gap, and we have got to try to examine what can be done about it, or if anything can be done.

I am concerned in a sense that when we held our last committee hearing on this subject, and I was here, the tax rate compliance was around 81 percent, and the Internal Revenue Service, I believe former Commissioner Eggers, said that the tax rate compliance figure is going down, and it is alarming. Those of us who are concerned with this question were alarmed that if the tax rate compliance went below 80 percent or to 70 percent, the system could blow up and we could believe it would not work then.

Now you tell me that the tax rate compliance level is approximately 83 percent and has gone up 3 percent instead of going down. Now, you have given me some reasons for the increased compliance. I say, well, that is encouraging. But I want to examine whether it is a fact and whether it is because we have got better information now, better personnel. Do we have better equipment, better workers; or have people just suddenly become better, more righteous in their taxpaying intentions?

I do not know the reasons. You gave me some of your estimates, but I kind of draw back when I see now your percentage of compliance is 83 as compared to 81 when you told me at our last review of the tax gap that it was going down.

Where is the difference in the tax rate compliance?

Let me start off by asking why do you not say to the public that the accounts receivable or our gap is higher than it really is? Can you defend the $85 billion?

Commissioner GIBBS. Mr. Chairman, again, I think one of the things we ought to distinguish between is the tax gap estimate on the one hand, and certain other financial and budget aspects on the other. You certainly have the accounts receivable. We certainly are able to predict yield for budgetary purposes. But I would like to make the point that with respect to the tax gap estimate, we use different analyses and different techniques to estimate what this tax gap is.

The tax gap itself, as I tried to indicate, is made up of several different things. It is made up, obviously, of individuals and corporations. It is made up of individuals and corporations who seek not to comply. In other words, I have often heard that the tax gap is a measure of cheating. That is only partially true. The tax gap is also made up of individuals and people in corporations who are not trying to cheat anyone. It is just that oftentimes they either make mistakes or they may not understand what their tax obligations are. We have had a number of discussions about that with the number of changes that we have had in our tax law.

So I think it is important as we begin the discussion about why certain things are happening to distinguish between what the tax gap estimates are and what the other financial information means.

Chairman PICKLE. Well, Commissioner, since you have mentioned the accounts receivable, where does accounts receivable fit into your tax gap estimate?

Commissioner GIBBS. Again, the tax gap estimates, Mr. Chairman, are simply our statistical analytical techniques for attempting to determine in the individual and corporate areas where compliance and noncompliance is taking place and the techniques that we use really do not have any direct impact in terms of computing the amount of our accounts receivable.

Now, there are some similarities. Both are affected by economic expansion and inflation. So there is that tie. But they are very different. The tax gap is analogous to an income statement item in a company's books while accounts receivable is analogous to a balance sheet item.

I am saying that the methodology in the tax gap report has no direct bearing on the accounts receivables themselves.

Chairman PICKLE. Well, employment taxes are an important part of the revenues of the IRS, and yet they are excluded in determining the tax gap. You have got $53 billion in accounts receivable. I am trying to figure is that an accurate part, is that any part of the tax gap? And you seem to think that it is not.

Commissioner GIBBS. Well, let me see if I can clarify it this way.

Remember the tax gap estimates that we are using are on a year by year basis. For example, we say in 1987 there is an $85 billion tax gap. Our accounts receivable are accumulated over a period of

years. It is not just one year that we are talking about with the accounts receivable. They grow over a period of years, and it is difficult to try to relate one to the other. That is all I am saying.

Chairman PICKLE. Well, I still say that it disturbs me that you give us an estimate of an $85 billion tax gap broken down between individuals and corporations. That figure does not take into account the fact that you exclude the employment taxes, excise taxes, and taxes owed by the underground economy. Those sources of taxes have to fit into this picture somewhere.

Now, you tell me that we do not get into that. You also say that illegal source income is hard to estimate, so you just almost brushed that one off. Then you talk about employment taxes, and you say we do not include that figure in your tax gap estimate because you really do not have a lot of good data to measure in mind.

It seems to me like that is a very generalized response to the fact that, if we are honest, we will see our tax gap is even greater. I do not know how these additional sources of revenue affect the tax compliance percentage.

So I am looking at those things in the broadest picture as we start out these hearings this morning, and I think we will come back to the accounts receivable and other revenue sources as we go along.

But I will come back to these other questions with you in just a minute.

Commissioner GIBBS. All right, Mr. Chairman, and I would also like to say I do not think we disagree. In other words, we recognize that there is an illegal sector. There are certainly tax gaps associated with employment tax and excise taxes, but they are not included in our estimates.

What I think we are saying is that we cannot measure those with the same precision that we can with the income tax area. We do not want to mix apples and oranges, things that we can measure fairly well and things that we cannot. Otherwise, we would damage the credibility of the report we are putting out.

Chairman PICKLE. I am impressed with your testimony, Commissioner, but I have to ask myself realistically when you say that in 1983 you made an estimate that our tax gap in 1987 would be $115 billion; now you have only got it $85 billion, and therefore you have done a good job and you have saved $30 billion.

On the other hand, you could ask yourself, you just made an error of $30 billion in your estimate 5 years ago and now you are just having to admit that you were wrong that much.

Which is it? I think we have to ask ourselves.

Commissioner GIBBS. And I think that is something we address in the report. What I think we are saying is that better and more current data, better estimating techniques, and also the impact of the legislation that, Mr. Chairman, I congratulate you and the other Members of Congress for passing. The 1983, 1984 and 1986 acts, are the reasons why the estimates have changed.

Chairman PICKLE. Well we will come back to other questions.

Let me ask Mr. Flippo if he has any questions.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Gibbs, I appreciate very much your testimony, and of course, what we are interested in is in terms of the administration of the

tax system, and your responsibilities for that. One way of looking at the tax gap is the measurement of compliance, taxpayer compliance. And that is really what we are trying to get our arms around here today, is taxpayer compliance improving, or is it declining?

And let me say to you that in the administration, I want to look at the positive aspects as well as the negative aspects, and let me start out by commending you. I notice that GAO gave the IRS some very high marks in your preparation for this tax filing season, and I know that you have shifted some resources into the taxpayer service area. Also, I know that you have made great efforts to improve employee training and retention of employees.

I noticed with great interest and approval that your tax shelter area seems to have doubled its settlement area, and I noticed that you also have initiated a study of the structure and effectiveness of the penalty area.

I commend you for all these initiatives and think that we ought to put them in the record so that we have a balanced record.

And let me quickly say that one of my concerns about tax compliance is that I am fearful that Congress may convey to your agency that it is more interested in revenue than it is fairness. I hope we are not conveying that message. I am concerned about conveying that, and I am particularly concerned if your agency is conveying to the taxpayer that we are also more interested in revenue than we are fairness because one of the reactions of the public, if they get that message, is to reduce their voluntary compliance with the tax code.

So I am asking you, is compliance up or down on the part of the American taxpayer?

Commissioner GIBBS. Mr. Flippo, we believe, as indicated by our estimate, that compliance is up, and frankly, I would also like to concur completely with the comments that you just made. I think it is important to remember that this tax gap is not made up of folks that are just unwilling to comply. It is also made up of folks that are unable to comply, and I think it is really important to get the balance out in terms of the fairness to the taxpayer, to convey that we have both a strong compliance effort, but also a strong taxpayer service assistance and education effort.

Mr. FLIPPO. Mr. Gibbs, in trying to understand whether or not this thing is improving or declining, and looking at your 1983 reports and your 1986 reports, and your current reports, it seems to me that you have changed significantly some definitions and some of the things that you have included in these reports, and that is what we are trying to understand here today.

Do you have the same things included in your estimate of a tax gap in the report you are giving us today that you did in the previous reports that you gave us?

Commissioner GIBBS. There are some things that are different, Mr. Flippo. We have tried to indicate what those are in the report, and we have also tried to indicate when we have changed why we have changed.

Mr. FLIPPO. Have you also indicated the amount of that change?

Commissioner GIBBS. Yes, we have. We certainly have.

Mr. FLIPPO. So if you had a comparable report to us today that you did the previous time, what would be the tax gap by any other definition you would care to use?

Commissioner GIBBS. Mr. Flippo, again, on page 10 of the report that we have shown, what we do is start with the old tax gap, indicate what the changes are that result in the new estimate of our tax gap, and again, the components of those are taking into account the impact of legislative changes on tax liability, new data that we have since the 1983 report, improved methods for estimating.

The only thing that we have omitted that we had in the prior report was the estimate of the so-called remittance gap where taxpayers are in effect filing their returns but not paying their tax, and the reason we did that, as indicated in the report, is because that information was so imprecise that we felt we ought to eliminate it while we are perfecting it.

When we do perfect it, we will indicate what it is.

Mr. FLIPPO. Well, let me move on to another area then because I have very limited time.

In looking at the 1986 report on taxpayer compliance, one of the articles in your 1986 annual report, was an article describing individual noncompliance. There was nothing mentioned in there about corporate noncompliance, and I am wondering why that is because you apparently have some significant noncompliance on the part of corporations.

Are you still emphasizing that in your latest report?

Commissioner GIBBS. Well, as I indicated in the report, we have estimated that the compliance gap for corporations has increased. We also are indicating that because of the lack of quality of data in the corporate area that we do have in the individual area, this is a much more imprecise estimate for the corporate tax gap. We do not have the amount or quality of data in the corporate area that we do in the individual area to estimate that gap, but we do indicate——

Mr. FLIPPO. Well, you have some other data. You have a program that you initiated I think in 1986 where you had a coordinated audit approach in corporations, in some of the corporations, and you have had some pretty good success with that, I believe.

Is that an area that I believe you report here some 1,450 corporations included in that program.

In other words, 45 percent of all of the deficiencies in the corporate area pertain to those 1,450 corporations.

Now, you seem to be collecting a lot of revenue when you go in there and do that. Why are you not doing more in that?

Commissioner GIBBS. Well, indeed we are, and in the tax gap estimate itself, the document that we have given you today, that is spelled out in some detail in terms of what the corporations are and also what we are doing.

Mr. FLIPPO. Well, Mr. Chairman, I just want to ask one more question, and then I will come back to it because I know I am taking too much time, but that seems to me like when you say you have a lot of information on taxpayer noncompliance, and then you do not, when you look at 70 percent of the corporate is in 1,450 areas, and then you say you do not have adequate information to

estimate that, it leaves some further questions that we would like to explore with you on another occasion.

Commissioner GIBBS. Mr. Flippo, could I clarify something?

Mr. FLIPPO. Yes.

Commissioner GIBBS. With respect to those corporations, we audit every year a much more substantial percentage of them than we do of smaller corporations and individuals. We do have information, substantial information, about what the audit results are, what the noncompliance amounts are, but we do not have the information in the same way that we do for individuals and smaller corporations. In other words, with individuals and smaller corporations, we can tell you on an item by item basis of income and deduction what the compliance rates are. And that is because we perform taxpayer compliance measurement audits.

We do not do that for the larger corporations because we actually audit so many of them on a continuing basis. That is the reason why there is a difference. But it does not mean that we do not have the information about what the compliance and noncompliance is for those larger corporations.

Mr. FLIPPO. Well, Mr. Chairman, I will defer my further questions until the other members.

Thank you.

Chairman PICKLE. The Chair recognizes Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Mr. Commissioner.

We were just having a brief discussion up here with the staff regarding the statement that small corporations account for about $5.2 billion in the so-called tax gap. There appears to be about 6 million small businesses, but of course, that includes sole proprietorships. That comes out to less than $1,000 per small business. I think you are going to almost have to have an agent at every small business if you are going to get it. Some of those things in small business are going to fall through the cracks. I do not see how even with increased compliance and increased enforcement, you are going to get much improvement.

I would like to have your opinion on that.

Commissioner GIBBS. Well, Mr. Schulze, when we talk about small corporations, maybe it is different in Philadelphia than it was in Dallas, but the definition is those with $10 million in assets and under. That is what we are calling a small corporation.

Now, even in Texas, particularly these days, $10 million in assets is a pretty good sized corporation. So part of the thing here may be a definitional issue.

Clearly we are not looking to allocate substantial resources to the very small businesses. Indeed, when you look at the dollars that they produce, it would not be a worthwhile expenditure.

On the other hand, from the standpoint of a balanced examination program, we do audit some of the small businesses, but as you grow in size up toward the $10 million in assets, then you can anticipate that we will take a little bit closer look.

Now, as you go over $10 million, between $10 million and $100 million, then you have a greater likelihood of being audited, and as I mentioned, if you are over $100 million in assets, then there is a pretty good chance we will see you every year.

Mr. SCHULZE. Thank you, Mr. Commissioner.

Now, I would like to talk about the broad based consumption tax.

As I look into this tax gap issue, it keeps coming out to me that the way to get greater compliance is some sort of value added tax. The complaint against the value added tax has always been that it costs so much, or costs so much in manpower, but it seems feasible to me if you have an efficient value added tax phased in over a period of time. We are concerned about an increasing tax gap and you are going to get half of it or more because it is very difficult to squeeze out the sides of a well organized value added tax.

Would a VAT not dramatically increase compliance?

Commissioner GIBBS. From the standpoint of a value added tax, you initially have, an overall policy question as to whether or not you wish to change the focus of tax away from the income tax and into something like a sales tax, and on the policy question I will defer to folks at the Treasury Department on the policy issue.

Mr. SCHULZE. I understand that, Mr. Commissioner.

Commissioner GIBBS. With respect to administration and compliance, from the information I have seen, I think that you are talking about a substantial compliance cost and substantial compliance resources if you go to a value added tax.

Mr. SCHULZE. If a value added tax, or if not a value added tax, how about a much simpler income tax code and a flat tax or a modified flat tax?

Now, in the last tax bill, one of the reasons we said we were going to get increased compliance was because we were eliminating complications and deductions. I do not know how many complications we eliminated, but we did eliminate some exemptions.

Mr. DORGAN. Would the gentleman yield? Is a modified flat tax an oxymoron? Could you have a modified flat tax?

Mr. SCHULZE. Certainly.

Mr. DORGAN. It would either be flat or not.

Mr. SCHULZE. Well, if you had a flat tax with a couple of gradations, I would say that could be a modified flat tax. It certainly would be closer to a flat tax than it would be to a progressive, extremely progressive tax. I know that you prefer 30 brackets with taking 100 percent over $100,000. [Laughter.]

But it seems to me a flat tax would increase compliance.

From your point of view, do you think the flatter we get the greater the compliance we would also get?

Commissioner GIBBS. Mr. Schulze, I honestly do not know what the effect of more or less progressive tax would be from the standpoint of compliance. I have not done that analysis, and I do not know what the answer would be. I can tell you this. I think that based upon what we are hearing and seeing, any way that we can simplify our Tax Code and make it easy to administer and for taxpayers to understand I think will have a salutary effect.

Mr. SCHULZE. If we said for argument's sake everybody was going to pay 10 percent of their gross income, period, that common sense would tell us that not only would that be simplification, but that would increase compliance because it would be relatively simple to administer and it would be relatively simple to adhere to.

So somewhere between that type of simplicity and our present complication I guess you could put a chart or a graph and show that compliance would decrease as complication increased.

So it seems to me just common sense that the flatter the tax, the more compliance we would get. But it also seems to me if you are talking about an ideal situation, you would be talking about a relatively flat tax. With some sort of value added tax, we all know the value added tax was started in Europe because of tremendous noncompliance. If we are serious about doing something about the tax gap and we are really concerned about everybody paying their fair share, then the major solution to that is to not put an IRS agent in every business and every home of the country, but it is to devise a system which, even though you try with an underground economy to get it out, squirt out the sides, results in some tax being paid on that product.

It seems to me when you look at that the only solution you can come up with would be a broad-based consumption tax which would get it at every level, and some sort of combination of that with a flat tax. We would then get increased compliance and a lot more money coming in.

Commissioner GIBBS. Mr. Schulze, I would like to simply comment that I think from my perspective, there really are two aspects of the confidence and respect that we need in order to make our tax system work, whatever tax system we have. One is that when people pay their fair share, I think they want to believe that if they are going to pay their fair share, others will, too, and if they do not, there is an agency that will cause others to pay their fair share. And that, it seems to me, argues for a strong compliance program.

But I think there is another aspect. I think that taxpayers also want to believe that if they are trying to comply and having difficulty in doing so, that there will be not only an agency that will help them, but will take that into account if they are examined or if they owe taxes, and that argues for a very strong service side of the Internal Revenue Service.

One of the things that I have been most pleased about with this subcommittee is that all of you have understood the need for a balance in the programs of the Internal Revenue Service, the funding for those programs and so forth, and frankly, I am delighted with the budget that we are requesting this year brings balance back into the service side and the compliance side of the Internal Revenue Service. I think it is very salutary, and I think that will have an impact on compliance.

Mr. SCHULZE. Well, Mr. Commissioner, let me say that your actions and reactions have also contributed to that, and for that we thank you.

Do you have any estimates on the sizes of the tax gap for illegal activities?

Commissioner GIBBS. Mr. Schulze, we really, as I indicated, one of the reasons why we have not included the illegal sector is because it is so very difficult to measure, and we do not have a sufficient measurement to make us comfortable in adding that into the tax gap. That is basically what I am saying.

I am not saying that it does not exist, but I am saying that it does not help to discuss it if you cannot quantify it in some credible fashion, and we simply do not have the information to be able to do that.

Mr. SCHULZE. Where there is normal withholding, do we not have over 99 percent compliance?

The average taxpayer complies, and complies fully, or almost, as fully as he can. And so where we have that type of structure, we have tremendous compliance, is that not true?

Commissioner GIBBS. That is correct, with wages and salaries, if you will take a look at page 5 of the study, we show that the compliance for filers is about 99½ percent, and even with pensions and annuities, where we have some discretionary withholding, it is still over the 98-percent level.

As we go to, for example, information reporting on interest and dividends, you still see a compliance level of 94.6 percent. As we have less information reporting, for example, in the capital gains area, the compliance rate drops to about 88 percent.

When we get down to people where there is no withholding, no information reporting, and they largely deal informally, off the books and in cash, such as your informal suppliers, your vendors, moonlighters and so forth, we are down to a compliance rate of 13.1 percent.

There is a message in there, I think, with respect to those compliance levels.

Mr. SCHULZE. In the corporate or business area, how much of the tax gap is due to business failures? It seems to me as a business gets into trouble, one of the first things it does is not send in the money that it owes to the Federal Government. That sort of thing is an increasing burden on them and one of the reasons that they eventually go under.

Is that included in your net figure?

Commissioner GIBBS. It is not. Those are basically unpaid employment taxes, and as I indicated, the employment and excise tax figures are not there.

Again, we do have information with respect to unpaid employment taxes, but it is not of the same type and quality as this information, so it would not be included.

Mr. SCHULZE. Thank you, Mr. Commissioner.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Schulze.

Let me comment at this point about the line of questioning.

The committee hearing today is to examine what is the tax gap, is it real both for individual and corporate, and what can we do about it, and I contend that it is larger than you have stated, and there are a lot of things we can do that we are not doing.

Now, the purpose of the hearing, from the chairman's standpoint, is not to talk about new sources of revenue. That could change a lot of things.

I am not prepared to say that is the answer, but if Mr. Schulze wants to recommend a value added tax, I will tell the chairman of our committee that he recommends that, or if Mr. Dorgan wants to modify that, or if either one of them wants a flat tax, I will pass

that information on, maybe the chairman of the full committee would like to have a hearing on revenue later.

Mr. SCHULZE. If the chairman would remember, in every major tax bill I have offered some form of value added tax, but it has not been accepted by the committee.

Chairman PICKLE. I am not arguing, Mr. Schulze. That might or might not be the eventual development. I do not know. But we are not going to settle that.

I hope we do not chase tax rabbits out here this morning on the revenue, and stay with what we are trying to establish.

I will say further to you, Commissioner, though, that it bothers me that you almost dismiss the underground economy and illegal economy.

I am saying to you it is the intention of this chairman to hold a hearing on that subject and giving you notice, now you go get some data. You say it is hard for you to estimate it when you do not know. The last time we had a hearing on this subject, the Commissioner of IRS did know and did estimate around, what, $10 billion, or at least, in revenue, and I think it would be two or three times that in drugs alone.

Now, to say that we just do not know, and so you cannot put your finger on it, it is elusive, but it has got to be examined.

So I am saying to you, I would be prepared for a hearing on the subject of the illegal economy.

Commissioner GIBBS. Mr. Chairman, I will look forward to the hearing because it is a very important subject.

Again, I am not saying that it is not there. What I am saying is that we cannot measure it with the precision that we have measured these other things with, and that is the reason that we have not included it.

Chairman PICKLE. Well, we must measure how we do something about it, and we must look at this thing seriously, and I think we will later.

Now, Mr. Dorgan?

Mr. DORGAN. Let me submit, Mr. Chairman, that I guess the Commissioner agrees that voluntary compliance among drug dealers is dreadfully low, and a hearing on that might be productive.

When I talked about Mr. Schulze's modified flat tax, the only point I was trying to make is that back home it is either flat or it ain't. Here, if it is flat when you start and then you have to change it, we do not change the wording, we just add a word to it and say now it is not flat but it is modified flat.

I just made the observation that only in this town does that kind of language work.

I would like to ask a couple of questions, Commissioner, about the general subject of the tax gap. You have reported today that there is some decrease in the tax gap, and my guess is that that has occurred for a couple of reasons. One, there have been some changes in the aggregate tax liability, and second, there have been changes in methods of computing the tax gap.

Is the tax gap still a severe problem in your judgment?

Commissioner GIBBS. Yes, it is, Mr. Dorgan.

I mentioned that we have good news and bad news. The good news is that while our estimate has gone down by $30 billion, the

bad news is it is still at the $85 billion level. I think that is a substantial problem.

Mr. DORGAN. Now, let me ask you, how can you narrow the tax gap? You know that a number of us have done some work in studying that area, and some have dismissed it as just sort of wild thinking, not very productive. Others have embraced it as the last best hope for mankind.

And my feeling is, clearly, if you have a tax gap in the neighborhood of $85 or $100 billion a year, and you are estimating this is going to grow to $114 billion by 1992, I believe, and you decide you are going to try and narrow it and set a goal for narrowing it, that there are certain things you can do to accomplish that.

How would you go about that if you had the reins and were able to do it?

Commissioner GIBBS. A combination of different ways and, frankly, all of you have touched on various aspects of them this morning, and I would like to go through them.

One of the reasons that we see a diminution in the size of the tax gap is because you have already done over the last several years a number of very important things. You have enhanced withholding, you have enhanced information reporting. You have given us the least intrusive tools to increase the amount of tax that is collected.

So I think keeping withholding and information reporting strong is one of the first elements that can be used to address the compliance gap.

The second one that I think is important is also something that we have undertaken, and that is to recognize that part of the compliance gap involves people's inability, not their unwillingness but their inability to comply in terms of needing better information, better assistance, processing returns better, providing better taxpayer assistance and education, those types of things, to in effect help people comply with the obligation, given the fact that the law has changed 19 times in 23 years is important.

If people know what their tax obligations are, I am persuaded that the overwhelming majority will comply, and we will have less of a compliance gap, and we will collect the money sooner.

The third way is meeting the tax compliance gap head on, for those who want to play in the grey areas or choose not to comply, and that is with a very strong compliance program in the examination, collection and criminal investigation areas.

Balancing each of the three elements, or all of them together I think is very important.

Mr. DORGAN. Some people think that anybody who is dealing with the tax gap will try to hire 800,000 more auditors and have an auditor in every living room 10 months of the year. Some of us believe, however, that another way exists to deal with this problem. With our complex tax system we need to provide much more taxpayer assistance than we now provide.

I know for a fact there are some folks in the administration who believe that taxpayer assistance is a net loser. I know there are others who fervently embrace the need for more assistance.

As you will recall, one of the recommendations of the Dorgan task force was an IRS Assistance Across America program which

would extend a helping hand to taxpayers to prepare returns, comply with the law, and answer questions.

How do you respond to that? Is taxpayer assistance a net loser, or can significant investments in taxpayer assistance help narrow the compliance problem?

Commissioner GIBBS. Mr. Dorgan, as I indicated just a minute ago, I really think that one of the key factors is better taxpayer assistance, education, support, if you will, for people trying to comply, particularly this time of the year.

I have to be candid to tell you that we are not as able to quantify what the impact of that is on voluntary compliance from the standpoint of producing revenue dollars, but I can tell you that with the literature that is beginning to be written on it, I think there is a recognition that this is an important aspect. It is certainly an element of the compliance gap, and the final comment I would like to make is that I think there is an administration recognition of this in the budget that we submitted this year.

Mr. DORGAN. Let me respond, if I might, to a point that Mr. Flippo made about fairness.

I think his point is correct, that the Internal Revenue Service has enormous power over the lives of our citizens and must operate with a very sensitive hand. The IRS must be very careful about how its enforcement, compliance, and collection efforts are carried out in this country. It must be done very sensitively. This is one aspect of fairness.

But there is another side of the fairness issue. The folks who are earning a wage and getting an income monthly with a W-2 form are complying at a 98, 99 percent rate. Those folks must pay income tax and there is no flexibility. They are chained to the income tax system, and there is nothing they are going to be able to do about it. But there are some other folks who are freeloaders. They are high flyers who do not pay their fair share.

Part of fairness to those law-abiding folks who pay their taxes every year is for us to make darned sure that we do not have a bunch of freeloaders in the system who pay nothing. That is the overriding issue of fairness that travels with this tax gap issue. It is why we must understand what enforcement and what assistance investments are necessary for the Internal Revenue Service to do its job.

Now, let me make one final comment, Mr. Chairman. I know that Mr. Schulze has never seen a consumption tax he did not like. I, on the other hand, think an income tax, properly constructed and properly administered, is a fair way to extract revenue from people to conduct the Government's business.

I must say that the income tax system today is rightfully complex. I understand that millions more are going to file short forms this year, and they will have advantages as a result of the 1986 Reform Act. Many people file long, complicated forms. We have to be sensitive to that complication. I think that complication also has a lot to do with the kind of compliance we get.

So all of us, I think, have to understand that base broadening very significantly adds to complication.

Fairness and simplicity do not always travel in the same direction. You say that in order to narrow the tax gap you need more

information. I understand what you are talking about, and more information means more complexity.

Mr. Schulze is wondering what I meant when I said fairness and simplicity do not always travel in the same direction. We could demonstrate that by pointing to dozens of provisions that were put in the 1986 Reform Act to make it more fair, but also at the same time make it more complex.

Commissioner GIBBS. Mr. Dorgan, if I could comment, I think I am in general agreement with you, but I have just a couple of observations.

Complexity can arise in two different ways. It can arise because rules are inherently complex. It also can arise because of the confusion that arises when relatively simple rules are changed again and again and again, and the one thing that I would urge as a tax administrator is that in the search for less inherently complex rules, we understand that there is a tradeoff as we keep changing the Internal Revenue Code. I think that we ought to take a very careful look at exactly who really is concerned about the complexity, because complexity can also be used as a statement of criticism by those that are having to pay more tax.

I would like to see a simpler code. I agree with that completely, and I think we are all in agreement with that. But I am also urging, as I have in the past, that we limit the velocity and magnitude of change, and that we also not get carried away too quickly with some of the complexity that we are hearing about today from folks that are using that as an excuse because they are having to pay tax for the first time.

Mr. DORGAN. I understand that.

I would say that some of those complaints today are real with respect to the long form.

Commissioner GIBBS. They are.

Mr. DORGAN. I would just observe that the promise every politician makes but never keeps is the promise to work for a simple income tax return. We have made it more complex, and we need to be attentive to our need to simplify it.

Chairman PICKLE. The Chair would remind the brethren that, let us come back to the text of the sermon today. We are trying to find out what is the tax gap and how real is it. Is it important? What can we do about it?

And we keep chasing these generalizations now about going to simplify. We just tried to simplify.

Mr. DORGAN. Mr. Chairman, the issue of complexity is directly related to the tax gap.

Chairman PICKLE. We all know that you cannot have fairness and simplicity at the same time, unless you went to a flat rate. And I am not willing to not discuss that, but I just hope that we can stay with what is our concern here today.

I was a little distressed here last month when we held a hearing on the taxpayer service and the emphasis seemed to be in the press throughout that the Tax Code is terribly complicated and people cannot write up their own returns, and we are just going to hell in a handbasket.

Well, we tried to simplify it in 1986. We hope we have. We do not know the answer to that yet. It may be a year before we will have

a good measurement on what we have done. But to say today that it is terribly complicated when we just tried to simplify it, it is just a generalization. It does not really get to the problem of what faces us.

We tried to simplify it. We hope we have. But we cannot promise the American people a rose garden on this tax thing. We have got to have taxes to run the Government.

Now, I am trying to say, how can we get the money that is out there that is owed us. And that is what I hope we can kind of concentrate on today more than anything else.

Mr. Thomas.

Mr. THOMAS. I thank the chairman. I do hope that our fundamental philosophy is not going out there and trying to get the money that is owed us, but that we have a system which the American people support, in which they freely pay that which they believe is an appropriate amount to receive the services from government.

I believe we have a fundamentally different philosophy if our goal is to go out there and find that which is owed us. I believe we do have a relationship between complexity and confusion now, and that perhaps over time it will settle more on the complexity and the confusion would diminish, I would hope.

I would tell the gentleman from the flatlands in the North that if you do go to bed with the sun and get up with the chickens, I understand why you have a problem with something like a modified flat tax. Deal with the terms "reasonable Democrat," "compassionate Republican," or try "dry lake," "airline food," "jumbo shrimp," and that sort of thing.

But for some of us, this question of a tax gap—and to me it is all definitional, and what one person considers an appropriate response someone else does not. So I just want to get a handle and realize what the chairman wants to focus on.

I have numbers that tell me that there is a tax gap for 1987 of $84.9 billion. That is gross or net?

Commissioner GIBBS. That is gross.

Mr. THOMAS. All right. You have categories of non-filers, filers, underreporting, overstatement, and math errors. The Service goes through and corrects the underreporting and the overstatement of deductions and math errors, right? I assume you make other corrections through your enforcement.

So what would be a net figure for the tax gap, rather than the gross of $84.9 billion? Or how good are we at closing the gap from that which we know, rather than that which we do not know?

Commissioner GIBBS. Mr. Thomas, we are in the process of determining what we are able to actually recover through our compliance efforts so that we can estimate the net tax gap. We do not have that at the present time. I hope to have it shortly.

But I would be happy to furnish it for the record when it is available. We are working on it at the present time.

But your assumption is correct that we do collect a part of the gross tax gap through our compliance and other programs.

Mr. THOMAS. We are not counting illegal dollars that otherwise should be taxed and the rest. So, what I am saying is, the difference between gross and net is a kind of a report card on the IRS in

terms of the tax gap, because the way you have it structured it is from information that we know.

Commissioner GIBBS. That is correct. It is basically what we are collecting with the resources that we presently have, that is correct.

Mr. THOMAS. Then we assume that there are folks out there not engaged in illegal activity. We have also, I think, eminently proven something that should be self-evident, that if someone else knows you tend to comply; if folks do not know, you do not tend to comply. There is an internal governor and an external governor, and the external governor seems to function a little better than the internal governor.

So to the degree that you can improve your reporting mechanisms for compliance, compliance goes up. To the degree that you enforce better, you have a better chance. And to the degree that you are a helping agency for people who are seeking help, you can close that gap.

On the other side, in terms of the taxpayers, I guess if you reduce the tax more people are willing to pay it, because the lower the tax the fairer the tax in most people's minds.

Simplification, I do not want to go down that route, but that would be one way in which you would get a higher compliance. The knowledge of the taxpayer that they are in fact making errors, which is part of the confusion aspect, would also improve it.

But I do not know, and I apologize because I came a little late, if you addressed it in your text. One of the things that I have found that I cannot figure out is why we have not done at the Federal level what they do with library books. If you owe a fine on a book, if you increase the fine that guarantees you do not get the book.

You know what happens periodically is, you get the notice coming out, everybody who has a book—nobody is going to watch you so, come on in and turn it in and we will forgive all the fines. Well, we get the books back.

So in terms of an amnesty program for the IRS, where are we? What success have we had in States, and what is the Federal position on an amnesty program?

Commissioner GIBBS. Within the last year or so, the Internal Revenue Service has concluded a study of the State amnesty programs and issued a report.

What we concluded was that you simply cannot generalize from the State experience to the Federal experience in attempting to project the number of dollars that would be raised with Federal amnesty. There are several reasons for that.

One, if you take a look at the State amnesties, what you tend to see is that the States rely on sales taxes and other types of taxes, that are substantially different from the taxes that we have at the Federal level.

Second, if you take a look at State amnesty programs you will find that many of the States indeed did not get collection from folks who came in from out of the cold, that is to say people who were not complying willfully. Indeed they offered a waiver of interest and penalties in some cases, or interest or penalties in others, and therefore were able to collect accounts receivable from people that were already identified on the books, largely because the State

enforcement programs before the amnesties were not what they are at the Federal level.

Third, when we actually looked at those who did come in from out of the cold at the State level, we found that a very substantial number of them were already reporting for Federal purposes—again, an indication of the lack of enforcement at the State level vis a vis the enforcement at the Federal level.

For that reason we concluded, based on the study that we did, that because of the relatively small amount of dollars that would be produced by a Federal amnesty and the potential impact, again going back to the fairness element of those who have been paying their taxes that it would be inadvisable at this point.

Mr. THOMAS. So there just are not enough folks out there. Those people who are not paying are not going to pay even if you put on the blindfold and say come on in, because they are not paying?

Commissioner GIBBS. We think the approach to take with those folks is not an amnesty, but rather to continue to do what we are already doing. And the reason is not only because of the potential impact on those folks that are not complying, but the potential impact you have in terms of cynicism for those who are complying and yet see the Federal Government——

Mr. THOMAS. Do you mean the attitude that sooner or later they are going to give me a window to come in?

Commissioner GIBBS. That is right.

Mr. THOMAS. Now, if we hold a hearing later on the tax gap in the illegal area, I hope we do not focus so much on the drugs and the rest, but I would be curious as to some estimates that might be generated on the number of domestics, whether they be gardeners or household workers, that are paid in cash.

Given what I consider to be a very complicated procedure, if you are going to comply with the rules on withholding and paying the Social Security tax and all the rest, then I think that would generate a significant amount of money. And some of the barter economy aspects that go on, I think that is an area that we can focus on.

But one of the things that something like a national sales tax would generate would be a source of revenue from purchases with those nontax dollars.

I do not think it is farfetched to try to figure out some kind of a procedure which relates those kind of taxes to income tax forms. It would reveal if someone generates a large number of sales and does not have any income tax. It is interesting in terms of a rebatable position on an income tax to pick up some folks who would pay it but get it back on their income tax, and others who do not pay but do not get it back because they do not file an income tax.

I know that sounds fairly complicated, but I am just saying that if we get some estimates of the size of the untaxed economy, and I think once we begin to get a handle on it it is going to be far larger than any of us think, that we can begin to look at some mechanisms which can begin to tap some flow of those expenditures that we do not now, whether it is income tax or not. That may be a fruitful way.

One last statement about enforcement, because I am all for enforcement, I am for giving you more folks to do the kind of thing you are trying to be doing. But I do think you reach a point not

only of diminishing returns, but of a difficult situation for us here as we pass tax bills which are designed to simplify and probably complicate.

I will not review who voted yes and who voted no on our recent round of simplifications. But you also get this kind of ambivalent position of voting money for enforcement in the IRS and supporting things like taxpayers bill of rights, which are designed to offset the attitude of folks out there about the increased enforcement of the IRS. You begin to be less effective when you run into these cross-purpose activities.

That enforcement is all well and good, but there is a point at which we have to agree that taxpayers are fundamentally law abiding when they have reporting forms and that they are making an honest attempt to comply. You folks are doing about as good as you can on the enforcement side, and that what is left over is something that we may have to live with.

Kind of like the unemployment rate, you cannot get it to zero.

Commissioner GIBBS. Mr. Thomas, can I comment on your statement, several aspects of it. I agree completely with the comment that it is very important for taxpayers to perceive and believe when they deal with the Internal Revenue Service that they are dealing with an agency that is going to be fair.

Indeed, as you gentlemen know, that is why I have introduced and am supporting the concept of working to spread quality and customer service throughout the organization, with the help of our union, with the help of various programs.

I do not disagree with the problems or the purposes of the bill of rights. What I have said in the past is that I think we have a disagreement about the way in which we ought to address the problems that are there, because they are important problems.

Now, having said that, let me also comment to you about something else that I think is really significant about this tax gap estimate, Mr. Chairman, to get us back on that subject. And that is this: under a prior estimate that we have done which was not updated for this report, so it was done with old figures, we estimated that it is not cost beneficial for the Internal Revenue Service to collect over two-thirds of the underground economy because it is in such small amounts, over so many people.

And in the final analysis, my opinion is that the only way you are really going to collect those dollars is to change people's attitudes with respect to their willingness and ability to comply.

And that is a major, major undertaking. It has been done elsewhere. We no longer in this country brag about drinking and driving. That used to be something that was discussed and it was socially fashionable.

I think in this country we still have an attitude today about whether it is socially acceptable, if you will, to cut a corner here or a corner there when it comes to the income tax area.

Now, I will submit to you that part of the attitude toward the Internal Revenue Service and part of the attitude within the Internal Revenue Service results from a period of time that we have gone through in this country where we have been very aggressive with one another in terms of how we have dealt with one another.

Taxpayers and practitioners have become more aggressive. The Internal Revenue Service and the Congress, passing penalty provisions and so forth, have become more aggressive.

What I hope we can do is step back and find a way for all of us to work together within the Internal Revenue Service, within the Congress and the public, to support the tax system in this country that will, we project, raise a trillion dollars next year.

But it is in addressing that two-thirds where it is not cost beneficial that I think is one of the major areas. If we could just improve compliance one percentage point, we are talking about over $5 billion that comes in.

Mr. THOMAS. Mr. Chairman, one last question. May I?

Chairman PICKLE. Thank you, Reverend Gibbs. [Laughter.]

Mr. Thomas.

Mr. THOMAS. It is reported to me from people in my district that they are finding that they are filling out forms for juveniles on the basis of the interest that they may have on a small amount of money and money they have earned, that are three dollar and five dollar returns.

Does the IRS have any estimate of what the average short form costs them to process?

Commissioner GIBBS. I would be happy to submit that for the record. We are also finding that this year, with a very low threshold for children, $500 plus a dollar in interest income, that we are going to have many more students who will be filing this year.

Mr. THOMAS. But the problem is the return is of a very, very de minimis amount. As you do with your rounding to the nearest dollar, less than that down to zero, I think if you could get a handle on what an average cost of processing a short form is that you are going to find that you are spending a lot of money to generate very small amounts of revenue.

Maybe you begin moving toward the concept of a de minimis amount, that if you go through the process and you find out it is x number of dollars and that is less than the cost of processing it, that you are not required to do it.

Commissioner GIBBS. Mr. Thomas, I would be glad to furnish that for the record. I think you will find when we furnish it that the average dollar amount will have to be very low, because on these 1040EZ's, as you may know, we can optically scan those when they come in. So the cost is not great to do that on a per return basis.

Mr. THOMAS. Well, I am talking now about returns being filed at $2 and $3.

[The following was subsequently received:]

AVERAGE COST OF PROCESSING SHORT FORM

It costs IRS $1.65 to process a Form 1040EZ and $1.91 to process a Form 1040A.

Mr. THOMAS. Thank you very much, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Thomas.

Now, Commissioner, I think each one of the members have additional questions and I have several, and we are going to proceed in a second round of questioning and we may come back based upon what kind of voting we may have on the floor.

Now let me go to my first subject area, in the area of audit. In 1986, it must have been 1986–87, you had only a 1.1 percent audit at the Internal Revenue Service. You estimate now in 1988 you will have a 1.19, I guess it is, a little increase.

Now, that sounds like a shockingly low number. Is that enough audits?

Commissioner GIBBS. Mr. Chairman, I very definitely would like to see that figure increase. I think it is a very low number. It is certainly down from where we were 10 or 20 years ago.

We do have other programs, such as document matching and revenue sharing with the states, but it is low.

Chairman PICKLE. Can you tell me how much higher you would like to have that audit percentage raised to?

Commissioner GIBBS. You know, Mr. Chairman, I really am reluctant to do that. But somewhere, I would say, in the two to 5-percent range is basically where I would like to see it.

Chairman PICKLE. Did you request an increase in the budget this year?

Commissioner GIBBS. Yes, Mr. Chairman, we did.

Chairman PICKLE. You requested an increase up to 5 percent?

Commissioner GIBBS. No, Mr. Chairman, it was not that high. And let me point out that you cannot go from where we are to something like a 2- or a 5-percent increase in 1 year, because of the limit that we have on our ability to recruit, train, and deploy the agents. It would have to be done over a period of years.

Chairman PICKLE. Well, I am simply trying to get some facts now and not something that is a profound generalization.

What kind of percentage did you ask for in the area of audit?

Commissioner GIBBS. We asked for—I can tell you the number of agents that we asked for, and I will be happy to supply for the record.

Chairman PICKLE. What did you ask for?

Commissioner GIBBS. I think we asked for 6,800 total additional personnel, was what we asked for this year, Mr. Chairman.

Chairman PICKLE. Well, I think it is important that you submit to our committee what you have asked for.

Commissioner GIBBS. I will.

[The following was subsequently received:]

IRS BUDGET REQUEST: PROPOSED REVENUE INITIATIVES

The FY 1989 IRS budget now pending before the Congress requests an additional 1,650 average positions to handle increased tax return workload resulting from growth in the taxpaying population and to design and program ADP modernization initiatives. IRS did request from the Office of Management and Budget additional staff (6,842 positions) for its revenue - producing programs. They were not approved for inclusion in the President's budget message. New revenue initiatives, including the third installment of the examination revenue initiative, were not contemplated by the bipartisan deficit reduction agreement. The proposed, but not approved, revenue initiatives are as follows:

IRS 1989 Revenue Initiatives
Dollars in Millions

Initiative	Ave. Pos.	Amount	FY 1989 Revenue	FY 1990 Revenue
Exam. Revenue Initiative	3,302	$147.7	$347	$858
Exam. Service Center TE Initiative	634	14.4	134	155
Information Returns Initiative	184	7.8	88	126
Collection TDI Initiative	2,018	86.3	408	869
Collection TDA Initiative	533	22.3	94	157
Returns Processing DATC	55	1.5	19	23
International	116	6.6	30	34
TOTAL	6,842	$286.6	$1,120	$2,222

Chairman PICKLE. I have it that in the area of personnel you had asked for about 1,600 people this year total, and you had asked for 32 less tax service personnel people than you have today. If that is a total and if those figures are correct, then they do not jibe with what you are trying to tell me.

Now, I am not trying to pin you down specifically as to what you did with audit. You said we ought to have more than a 1.1 and you are going up to 1.19, and you think you would like to go up to 5 percent.

Now, I am simply trying to say, did you request that?

Commissioner GIBBS. Yes, we did.

Chairman PICKLE. Are you requesting extra personnel? In what other categories are you asking for other personnel? Have you asked for increased personnel in the enforcement field?

Commissioner GIBBS. Mr. Chairman, we requested it. What I am told is this: that because of the budget summit agreement, the bill that has come down is in accordance with the budget summit agreement, our request to the Congress is somewhat lower than what the Internal Revenue Service requested to OMB.

Chairman PICKLE. Mr. Commissioner, I just do not understand what you are saying. I would like to have from you more specifics—let me review for you. Last year this committee recommended to the Appropriations Committee extra funds for the Internal Revenue Service. We had an awful hard time the last 3 of 4 years to get them to ever recommend anything.

But we did get you $58 million more. Now, I would ask you, how did you spend that money? Did you spend that money for taxpayer services?

Commissioner GIBBS. Mr. Chairman, you recommended to the Appropriations Committee $58 million. We were ultimately given $7 million, and we reallocated $51 million to get back to the $58 million.

Chairman PICKLE. Whether you reallocated or not, you got $58 million more. Some of it did come from the FERS, the supplemental fund, that is true. Appropriations gave you $7 million more, but you had the total of $58 million to spend.

Now, I am asking you, is it for taxpayer services? I am simply asking, did you spend it for taxpayer services?

Commissioner GIBBS. Absolutely.

Chairman PICKLE. You did not spend it for other things?

Commissioner GIBBS. No, sir.

Chairman PICKLE. Now, the question is, now you have got those extra people. And I want to say to you that I believe you are the first Commissioner who has really put emphasis on taxpayer services. I personally think you are doing a good job. I am proud of what the IRS people in my city are doing. I think it is a national spirit that the IRS folks are feeling, and that is very encouraging. And so I compliment you on what you are doing.

But I am simply asking now, what do you want in the way of personnel, and do you want additional personnel? Do you want an increase in audit? Do you need more compliance personnel?

And I have yet to see any administration that I can remember that has come up and said, we want a larger number of enforce-

ment personnel. And I do not know whether Congress would give it to you, because there is something kind of unpopular about it.

But I am simply saying to you, I want to know what you are requesting, and it seems to be at great variance with what you told me in the generalized answer as to what you requested.

I just want to know what you have requested in the budget, and do you want our help to help you get that? If you do, well, tell us and let us know. But I do not want to say that we ought to have all this help and then you never request it, never ask for it. I think if you want it and you need it, we ought to try to recommend it if we think it is a good thing.

So let us know what it is.

Now, the next question I want to ask is the following. You said that you just do not know, and Mr. Thomas did ask you, what is the net amount of collection that you think you can get. And you said you just do not know that.

Now, you did say you did not think two-thirds of the underground economy could be collected in an economically feasible manner. You gave me an estimate on that. But you do not even give an estimate on what you think is the net tax gap, that is, the amount we can really collect.

Now, it seems to me you ought to give me more. And you said you would submit that later, and I find that unacceptable. Do you think you can collect, of this $85 billion, can you collect 50 percent of it?

Commissioner GIBBS. Mr. Chairman, with respect to the number that I was talking about, it is for fiscal 1987. Fiscal 1987 was concluded September 30 last year. We are still in the process of putting that together. We can provide it to you.

And it is not that I am unwilling to provide it. It is that I am unable to presently provide it to you for 1987 in terms of what we actually did with the funds that we were given in terms of the compliance that we had.

Chairman PICKLE. Mr. Commissioner, you and your agency are bound to know about how much of that money is realistically going to be collectable. You know that. If you do not, we ought to fire a bunch of people down the street.

And I am not trying to pin you to it. I am just saying, realistically what might we expect? And if you do not know now, then I am surprised. But submit it to me as soon as you can.

Commissioner GIBBS. Can I explain? Because we know what we collected, Mr. Chairman. I mean, we have got that, and that is about $46 billion that we collected. But I cannot tell you that it is applicable specifically to this gap.

This estimate is a 1987 gap, we will be collecting parts of it over a period of years. Now, when we have the information I will be delighted to share it with you.

Chairman PICKLE. Well, when you have it you are going to submit me that. We would like to know when you do submit it, I think we would like to know what areas of taxpayer noncompliance will the IRS never be able to improve upon, because it is either too complex or whether it is too difficult to detect or whatever.

You ought to give us those areas, too, when you finally come to that.

Commissioner GIBBS. Can I back up and give something else for the record that might help you.

Chairman PICKLE. Yes, sir.

Commissioner GIBBS. We do have a footnote. It is the first footnote in our report, and it states:

> The IRS annually collects over $20 billion of income tax through enforcement programs. Estimates of the net tax gap are currently being developed for publication in a later report. The report should be available later this year.

And so we tried to give you some information, but also indicate that, with respect to the specifics, it will be available later this year.

Chairman PICKLE. Well, we will of course wait for that time, and I hope you can get us something more accurate sooner than that.

Now, Mr. Chairman, I believe it was Mr. Thomas that raised the question about if we have an underground economy, we ought to broaden that to include an investigation of a lot of the cash transactions that are going on that we never hear about and are never reported and therefore there is no record of it.

With unreported income being the largest component of the overall tax gap, estimated as about $48 billion in your study, how effective are the IRS enforcement programs? I guess what I am really driving at is what—would information reporting on other sources of income besides wages, salaries, pensions, and annuities, and interest and dividends help reduce the tax gap?

Commissioner GIBBS. In my opinion——

Chairman PICKLE. How can you get closer to the source of income by way of reporting? Would that help?

Commissioner GIBBS. Mr. Chairman, I think it would help, yes.

Chairman PICKLE. Well, what can you do to improve that? Are you recommending that we improve it? I think you want to improve it in individuals. I do not see much recommendation you are making about reporting it in the corporate field.

Commissioner GIBBS. We are doing several things in the corporate field, Mr. Chairman, because of——

Chairman PICKLE. Enlighten me, then.

Commissioner GIBBS. I would be happy to. As a result of requests that we have previously received for more accurate data as to what the cost-benefit would be in the corporate area, we are conducting over the next 2 years an analysis of what is not currently being collected in the corporate area, that we could collect with more information reporting.

The reason that we are doing the cost-benefit analysis is that the bulk of the dollars come from your larger corporations. Those corporations are corporations which have audited financial statements, and we largely are auditing most of them at the present time.

For that reason, we are concerned because the cost will be substantial to institute additional information reporting in the corporate area. We think that it is appropriate before we spend those dollars to try to get some idea of what the cost-benefit will be. That is what we are doing over the next several years.

Chairman PICKLE. Now, earlier you said that you were confident that if the average individual knew what his tax really was that he would comply, he would fill out the forms and submit his money. Now, we go to audit corporations. They know how to comply. They have got the smartest tax lawyers in the country. But they do not comply, and you do not do anything about it, it appears.

Commissioner GIBBS. Mr. Chairman, I do not think that is accurate. I think we do audit them. I think from the standpoint of the audit dollars that we produce, they are substantial, and particularly from the large corporations.

But again, from the standpoint of information reporting, we suspect that we are going to have a relatively high compliance rate with things that would ordinarily be reported on information reports—interest, dividends, rents, royalties, that type of thing. We do not find a high noncompliance rate there in the audits that we perform.

Chairman PICKLE. Well, we both will agree, I am sure, Commissioner, that the closer we can get to the source of income as to reporting, the more accurate the compliance rate is going to be and the better our government is going to be.

Now, how far and how can you do that? That is what we are looking for, some kind of recommendation. We know that in the area of the W-2's the compliance rates are around 95, 98 percent or more. If we can just extend that same type of collection or if you think it is feasible, then we would know that a lot of these problems would disappear.

Now, how we do it is what we are looking for, how to go about it. Now, I want to come back to that question, but I am going to recognize some of the other members.

Commissioner GIBBS. And Mr. Chairman, please do not think that—we are going to make a study, and if we do find that it is cost beneficial, then we will come back with suggestions.

Chairman PICKLE. And we would like to know in what areas you would make those recommendations.

Commissioner GIBBS. Fair enough.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you.

Mr. Gibbs, I would like to pursue that particular point with you. But first of all, it is obvious to me that we have a lot of misunderstanding about what the definition of a tax gap is. And I guess there are as many definitions as there are people trying to deal with it.

But I wonder if it would be—do you think it would be a great deal of trouble if you would take previous reports and restate your projection using the methodologies, the assumptions, and the projections that were used before, and give us some kind of comparison as to what the tax gap is today as a percentage of revenues?

What I am interested in the tax gap for is to try to make some kind of evaluation as to how we might improve the compliance percentage with our Tax Code. Is that not—what is your feeling about why we need to estimate a tax gap?

Commissioner GIBBS. I think the reason for estimating a tax gap is to attempt to determine, first of all, what part of the tax is being collected through voluntary compliance.

I think that is important. I think that is important for us to know.

And then second, beyond voluntary compliance, what could we do with involuntary methods, such as enforcement? What could we do with better taxpayer service, that type of thing?

Mr. FLIPPO. So it is important to you as a tax administrator in the allocation of your resources in the administration of the tax law, is that correct?

Commissioner GIBBS. I would say that is part of it, yes.

Mr. FLIPPO. Well, what else is it, if it is not to assist in the allocation of resources so that you can make recommendations as to what changes we need to make?

Commissioner GIBBS. Well again, as I mentioned, if you will accept the fact that a substantial part of the tax gap is impacted relatively little with respect to how the IRS would allocate its resources—that is to say the portion where it is simply not cost beneficial to collect through enforcement—then I think that is an important statistic to know, because it means that we are going to have to do something to improve voluntary compliance.

And the Internal Revenue Service can certainly do part of it, but we are going to have to do something with respect to changing attitudes if that amount is to be collected.

Mr. FLIPPO. Well, I am interested in changing attitudes, yes, very much. But the point I am asking you, is the tax gap relevant to you in terms of an administrator of the tax law and the allocation of your resources?

Commissioner GIBBS. Yes.

Mr. FLIPPO. And if it is, then I assume it suggests areas to you for improvement. I assume your motivation is to increase compliance and decrease the tax gap?

Commissioner GIBBS. Yes.

Mr. FLIPPO. So could you go back and help us understand how that tax gap is doing by giving us some kind of consistent comparisons in both definition and projection methods?

It seems to me that you have made substantial changes in the definition of the tax gap and you have explained those and footnoted those. But I think it would be helpful to us to make an evaluation as to whether or not it is going up or down to have—I mean, you would require a company to report income to you on a consistent basis.

So I am trying to figure out whether or not the tax gap is going up or down as a percentage of our revenue collected. Is that not a reasonable request, and do you not in fact have to have such an analysis before you can use the tax gap measure to assist you in the allocation of the resources?

Commissioner GIBBS. Mr. Flippo, let me be sure I understand your question. If your question is as to the changes that we have made in our methodology, can we really estimate what is happening to tax compliance, the answer is yes, I think we can.

And indeed we have done so, I believe, on page 7 of the report, because the compliance rates are based on the methodology that we have been using for individuals, filers and nonfilers, and for corporations.

When we get to the bottom of the table on page 7, we can show what the compliance rates have been.

Mr. FLIPPO. Well, I am sorry, I must not be looking at the same thing as you are looking. But anyway, I do not want to spend all my time on that.

Commissioner GIBBS. I want to be sure, though, that I am responsive to what your concerns are.

Mr. FLIPPO. Well, as I look at your testimony I do not see——

Commissioner GIBBS. No, it is in the study. I am sorry, the study itself.

Mr. FLIPPO. Well, let me have your interpretation of what this shows then.

Commissioner GIBBS. All right. From the standpoint of the voluntary compliance rates for individuals, they went from 84.6 percent in 1973, down to 81 percent in 1986, increasing to 83.5 percent in 1987, to 84 percent in 1988, and 84.9 percent in 1992.

Mr. FLIPPO. So from 1973 the tax compliance rate you say is increasing.

Commissioner GIBBS. Well, it decreased from 1973, from——

Mr. FLIPPO. Well, Mr. Gibbs, let us go on to some other area. I perhaps need to discuss with some of your staff that issue so that I can understand what we are talking about.

But I just want a consistent projection of this tax gap to make some measurement of it. But let us come on to another area.

In your 1986 report, and the point that the chairman was talking about in regard to corporate noncompliance and you were talking about, if you can do it you're going to do a study so that you can see whether or not the efforts would be cost effective in some areas.

Now, in these 1,450 corporations, have you not had— has not in fact 45 percent of all the deficiencies proposed in 1986 pertained to those 1,450 corporations? Now, you have a CEP program going on those corporations?

Commissioner GIBBS. Yes, we do.

Mr. FLIPPO. And 70 percent of the deficit——

Commissioner GIBBS. Excuse me, I am sorry. Was the question do we have a TCMP?

Mr. FLIPPO. No, I said you have coordinated audits taking place of the 1,450 corporations and the results of that, and you estimate that 70 percent of whatever the tax gap is in the corporate area is in those areas?

Commissioner GIBBS. That is correct.

Mr. FLIPPO. You have teams out there and have had for what, two years?

Commissioner GIBBS. For quite a while, much longer than that.

Mr. FLIPPO. And they have been very effective, and so your methodology and procedures apparently, that is a working, successful program?

Commissioner GIBBS. Yes.

Mr. FLIPPO. Do you need two years to evaluate whether or not an extension of that program is effective?

Commissioner GIBBS. Yes, sir. And let me explain why: because from an information reporting standpoint, we are talking about only certain types of income, and that is not the type of income where we are seeing the noncompliance in the large corporations.

It is interest, dividends, rents, royalties, those types of things. And what we are saying is, based upon our examination that is not where we are seeing the noncompliance in those large corporations.

Mr. FLIPPO. Well, Mr. Gibbs, under your old corporate tax gap estimate for 1986 you estimated the corporate gap at $9.7 billion, and yet examinations proposed almost $11 billion. So you significantly underestimated the amount of revenue that could be addressed in that specific area. How do you explain that?

I mean, would that not suggest that maybe your estimating methods need some improvement, and that that ought to be an area of profitable examination?

Commissioner GIBBS. Mr. Chairman, you are correct, our estimate that we originally used was low in the corporate area. With respect to the estimate that we are presently using, particularly for 1987 and beyond, it can be alleged that, if anything, we have overcorrected and that it is high.

Let me explain what I am talking about. The reason our methodology for 1987 was to take the compliance rate for corporations from past years, the average compliance rate, which is about 82.5 percent, and simply apply that compliance rate against a larger base of tax in the corporate area.

Now, why do we have more tax in the corporate area? We have more tax in the corporate area largely because of the repeal of the investment credit. So we have taken away a benefit.

Arguably, when you take away that benefit you eliminate an opportunity for noncompliance. And what that would argue for would be an increased rate of compliance by corporations.

Furthermore, as you reduce the corporate tax rates, arguably you ought to see a diminution in the corporate tax gaps. So some people would say that simply projecting the noncompliance rate that we have had in the past or the compliance rate, the 82.5 percent, really is inappropriate after 1987, and indeed corporate compliance will go up.

We are saying that may be true, but we do not have the capacity to measure that and therefore we are going to stay with the methodology that we have used in the past. It is imprecise and we admit that in the report.

Mr. FLIPPO. Well, I am used to significant degrees of imprecision in government in many ways. But it looks to me like your estimate has gone from about $11 billion up almost double in the amount of noncompliance. It would not take a study to see that you have been very profitable in applying resources in these 1,450 corporations. It would not take a study to understand that you have many repeated offenders in there.

Can the CEP program be expanded to include more corporations? It is very profitable. If so, can it be? And if so, why has it not been done? And if not, why not?

Commissioner GIBBS. Do you mean expanded from the standpoint of taking in more corporations? Because at the present time in that 1,400——

Mr. FLIPPO. I am talking about cost efficiency in terms of collecting revenue dollars for noncompliance. It is obviously a cost-efficient program.

Commissioner GIBBS. It is a cost-efficient program.

Mr. FLIPPO. You do not need a study to determine that.

Commissioner GIBBS. No. And I am a little bit confused what your question is, because we currently have such a high audit rate in that group.

Mr. FLIPPO. You have a high audit rate, but you do not have a coordinated high audit rate. The CEP program is not applied to all of those corporations, is it?

Commissioner GIBBS. Well, with the corporations that are in that group, Mr. Flippo, we are auditing most of them every year. And we come around often enough——

Mr. FLIPPO. But you are not auditing, you are not having a coordinated audit of those corporations every year, are you?

Commissioner GIBBS. Yes.

Mr. FLIPPO. Of the entire 1,450?

Commissioner GIBBS. Not of the entire amount, but it is up over 80, 85 percent of those. And you are audited on a fairly continuous basis if you are in that group. You may not be audited every year. Some corporations in that group are audited every year.

But we audit them enough so that we feel we really do get a very close to 100 percent audit rate in that group of the coordinated examination program group.

Mr. FLIPPO. Well, in other words are you suggesting that you have extended the CEP program as far as it is cost effective to do?

Commissioner GIBBS. Not necessarily. We are continuing to seek ways to improve our corporate examination programs. As a matter of fact, one of the things—and Mr. Flippo, I announced to the business executives that largely represent those corporations yesterday that we have several new programs involving coordination with our examination people, our people in appeals, and attorneys, to try to do a better job in our large case program to be more effective and, frankly, to enhance the recoverable tax dollars, by raising the right issues and by developing them in such a way that we are more likely to be successful in the event of litigation or settlement.

And so the answer is that we are doing more in that area.

Mr. FLIPPO. I thank the gentleman for his response.

Thank you, Mr. Chairman.

Chairman PICKLE. Well, Mr. Commissioner, let me thank you. Let me ask you one or two more questions.

Should the individuals or corporations report to the Internal Revenue Service the amount in royalty paid to other taxpayers?

Commissioner GIBBS. Mr. Chairman, I will have to defer on that. I thought we did have a provision added as a result of the 1986 act involving reporting on royalties.

Chairman PICKLE. I am trying to get at what kind of reporting is made. We will say in the corporate field, should they report any payments in dividends and royalties?

What about dividends and withholdings? Do you recommend that we ought to collect on dividends and withholdings, corporate reporting from the banks?

Commissioner GIBBS. I am sorry. You are talking about the corporate area?

Chairman PICKLE. Yes.

Commissioner GIBBS. I beg your pardon. Again, that is what we are doing the study to determine.

Chairman PICKLE. Well, you have, what do you call it, a coordinated exam program? What is it?

Mr. FLIPPO. Would the distinguished chairman yield?

Chairman PICKLE. I am talking about the CEP.

Mr. FLIPPO. Would the distinguished chairman yield to me for just one question on that point? If I understand it right, Mr. Gibbs, there are 4,400 large corporations in the United States with assets of more than $250 million.

In that kind of category, you currently have about 1,450 corporations in your coordinated audit program that are the target companies that you and I have been discussing. That is the information that I have. If that is incorrect, I would like for you to correctly state it.

What I am asking you is, can we expand the CEP program, the coordinated audit program, to at least half of the 4,400 large corporations in the United States?

Commissioner GIBBS. Mr. Flippo, I will be happy to respond to you on that. I do not have our Assistant Commissioner for Examination here, and what I would like to do is to talk to that person, and then I would be glad to respond on that.

[The following was subsequently received:]

Your question identifies a significant issue and one upon which we continually focus because we recognize that the Coordinated Examination Program (CEP) produces substantial revenue. In fact, in terms of return for investment, it is our best producing program. Consequently, we review its composition on an annual basis to assure that cases included in the CEP continue to warrant a team examination and to identify other cases which should be added to the program. Over the past years, we have continually increased the number of CEP cases. To understand why we feel the CEP is already covering an appropriate population, I think it would be helpful for me to explain the program and its operations.

The Coordinated Examination Program focuses resources on the examination of the largest and most complex taxpayers filing returns in our country. These large case audits include the examination of the principal tax returns as well as the many related returns filed by the key taxpayers' subsidiaries (both foreign and domestic), its partnerships and, at times, its officers. When we speak of a CEP case, we are referring to our key or controlling case. Associated with the CEP case are numerous other returns and tax years. Therefore when we say there are approximately 1,450 cases in the CEP, we are referring only to the controlling cases. When we include all of the related entities this number would be several times larger.

To understand why certain cases are selected for examination under this program while others are not, it is helpful to keep in mind two fundamental elements of the CEP. The first of these elements is the point process by which a taxpayer is "measured" for inclusion in the CEP. The second element requires that the taxpayer's business activity be so complex or diverse that its examination by a single agent is not practical. It is from this element that the concept of a coordinated examination or team audit approach arises.

Generally, before a return can be selected for examination within the program, it must pass three tests:

1. The taxpayers are assigned sufficient points based on a variety of criteria (see following criteria).

2. The complexity of the case warrants a team examination approach.

3. There is a high probability that the examination will produce a change to the tax liability.

The point criteria are used to determine whether the case is of the size and complexity to warrant inclusion in the CEP.

CEP Criteria

Gross Assets	-	Points are awarded based on broad asset ranges (e.g., $1-$2 billion receives 3 points)
Gross Receipts	-	Points are awarded based on gross receipts (e.g., $1-$2 billion receives 2 points).
Operating Entities	-	Points are awarded based on the number of major subsidiaries, branches and divisions requiring examination (e.g., 2-5 entities receive 3 points, over 13 entities receive 9 points).
Multiple Industry Status	-	One point is awarded for each separate and distinct major industry (e.g., insurance, stock brokerage).
Specialists	-	One point (no maximum) is awarded for each specialist (e.g., International Examiner, Computer Specialist, etc.) required by the case.
Team Members	-	One point is awarded for each agent who is scheduled to devote 25 or more staffdays to the case.

It can be seen from the above criteria that the assets of a given taxpayer is only one of the criteria we use to measure a case's suitability for the CEP. And it is because of these other criteria that many of the largest corporations, in terms of assets alone, are not examined using the team audit technique.

However, just because a case has met this criteria and been included in the program does not mean it will be examined. This decision is made by our case managers, who determine if the case has potential for additional revenue. In addition to past productivity of the case, some factors the case manager considers are specific occurrences, such as reorganizations, acquisition, liquidation, changes in method of accounting, significant taxpayer elections and private letter rulings.

If audit potential is found, the case manager makes a last, but very significant decision. This is, would the examination of this return be best conducted utilizing team-audit procedures. The term "team audit" means two or more agents with the required degree of experience and specialized talents working as members

of an examination team led by a case manager. Failing this final test, any case with audit potential will most likely be examined, but not under the purview of the Coordinated Examination Program.

Those large corporations ($100 million or more of assets) not selected for the CEP program are sent to our districts for screening. This is an automatic program that annually identifies all of these returns for district screening. These returns are classified by senior revenue agents for examination issues. The returns with the greatest audit potential are examined by our most senior revenue agents as part of our overall audit program. There is also the possibility that one of these returns could become a CEP case. For example, the audit of a non CEP corporation may reveal a substantial number of related entities and returns. Through these related returns we may find that the best method to audit this corporation is through the CEP team approach. This return would then become part of the CEP.

In summary then, our Coordinated Examination Program includes approximately 1450 key cases, the vast majority being corporation with more than $250 million in assets, which are large, diverse, complex entities requiring a team effort to produce an effective examination. Because of these standards and our annual review of all large corporate tax returns, we believe the program includes all cases which should be included. Said another way, we do not think that the addition of other cases to the CEP based solely on a measurement of their total assets would produce the kind of results for which we are all looking.

Mr. FLIPPO. Thank you, and I thank the chairman.

Chairman PICKLE. Let us go a step further. You are not just going to talk to him and say, what is your opinion. What is your opinion? Can we or should we expand the CEP program to cover a larger number of the corporate entities that you have got now?

Should we?

Commissioner GIBBS. Mr. Chairman, I do not know. I honestly do not know what the considerations are in doing this, to be honest with you.

Chairman PICKLE. Then I would like to know what you would propose and how you would do it, and do we need extra assistance from this angle to do it? We start from the premise that we know we collect most of our money under the W-2's. That is close to the source.

Now, how can we expand that into the corporate area? And we do not have the same W-2 problem, but we do have a problem in relation to royalties, dividends, and interest and other sources of revenue? How can we get to the corporate sector and get better compliance?

While we cannot accuse them, we know that in many instances they just do not comply with the tax laws, and they are looking for every way to deduct and not pay taxes. That seems to be the philosophy of a lot of Americans. They love this country, but they will do everything they can to keep from paying a federal dollar in tax. I do not know why that is. I guess that is human nature.

So we need to find out, how can we get better compliance at the source? And that includes both individuals and corporations in the legal economy, whether it is domestic workers or other taxpayers. And that is what we are striving for.

Now, I think your tax gap study has been helpful. I do not understand why we waited five years to have a tax gap study. I hope we do not have to wait another 5 years, but if we do I would be happy if you would be around. I hope we are both around in that period.

But we need to be kept more current on what we are doing.

Now, you know and I know that there is a lot of money out there that has not been paid. And you and I know that it is not just that it is owed to the government. I mean, we do not want to be harsh tax collectors, but we do know that taxes are a necessary part of our function. If money has not been paid, it ought to be paid, if for no other reason than to make the taxpayer who is paying the bill feel that he is paying is fair share and that he is not being a sucker.

And if we do not have appropriate tax compliance and payment, then the whole system could come crumbling down.

Now, this has been helpful to me. It seems to me that it disturbs me, though, that you have not really leveled with me or with the committee in the sense that you are really going to do something about this, because you say we have a tax gap, but we know it is larger than that, and you really do not have a plan about how you are going to collect these things.

I would like for you to be as aggressive as you can. And if we can agree on how we are going to go about it, I think this committee could make recommendations to the Appropriations Committee

and would try to enlist the administration's help to bring these about.

We need the revenue. But more than that, in all fairness, if we do not collect it we hurt the system. So I would like for you as Commissioner of Internal Revenue to concentrate on that.

I repeat now again: I think your efforts in the taxpayers service has been most commendable. I think for the first time people in the Internal Revenue Service, not for the first time but more so now, are trying to find ways that they can accommodate the public.

We get criticism every day where someone in IRS says, if you do not pay this bill tonight or by tomorrow morning 10 o'clock, I am going to close you down. And I know there is always a flip side to that, because you know that represents months and months of negotiations.

But the attitude of the average IRS employee, I think, has improved. I think they are really trying to help and make the public realize that they are out to help the taxpayers across the country.

Now, if we need more personnel, we want to try and help you get them. But I just do not want us to cavalierly say, well, we have got a lot of money out there and there is not any way to collect it, and we are doing the best we can, and what is the next subject.

There is something we can improve our processes, and I hope we do that.

Now, I told you we are going to have another hearing on this, not only on this subject but also in the taxpayers services, particularly with reference to the telephone responses. We will try to do that within the next 2 weeks or at least say the next 30 days.

And I hope by that time, if we do, you might give us some suggestions along the line we have talked this morning, just to see what you would recommend or what you think the administration would support. And I will see if we can look at that over here.

So if we did have a hearing in another 15 or 30 days, could you perhaps give us some of your recommendations on points we have discussed this morning?

Commissioner GIBBS. Yes, Mr. Chairman.

I would like to distinguish between two things, because I agree with what you said, but I would like to clarify one point that you made. In preparing this report, we have several areas that we have not included that were in our prior report.

One was the illegal economy.

Chairman PICKLE. The illegal what?

Commissioner GIBBS. The tax gap from the so-called illegal sector, organized crime, narcotics, that type of thing. We did have a portion of that in the prior report. It has not been included in the present report because of a concern that we really cannot measure it, but it does not mean that we are not doing things or that we ought not to do more.

And I will be happy to discuss what we are doing and what more we can do in the area. But because it is not in this report, that does not mean that we are not doing something there.

And indeed, the same thing is true with respect to the remittance gap, which was included in the prior report, but has not been included in this report. We are doing a number of things in that area and we will have that information available, because on that

one we think that we will be able to eventually get some information.

Chairman PICKLE. Do you know now what the remittance gap is, the amount in the remittance gap?

Commissioner GIBBS. That is my point. At the present time—we estimated previously that the remittance gap was about $7 billion. That was the estimate that we made in 1983 for 1987, and what we are saying is we do not believe that the figure is correct.

We are still working to come up with a figure, but we do not have it yet.

Chairman PICKLE. Well, the committee intends to submit you some additional questions, and I know you will look forward to answering those.

We will do that very quickly so that you have a chance to respond in anticipation of the next meeting.

[The questions and answers follow:]

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March 24, 1988

The Honorable Lawrence B. Gibbs, Jr.
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

I want to thank you for your testimony at the Oversight Subcommittee's hearing on the tax gap and the current compliance levels with the tax laws. To complete our hearing record I would appreciate having your responses to the following questions pertaining thereto by the close of business, Thursday, April 7, 1988:

1. The 1988 Income Tax Compliance study shows the tax gap has almost tripled since 1973, from $28.4 billion in 1973 to $84.9 billion in 1987, and IRS attributes the growth largely to increased income tax liabilities from "real expansion in the economy and inflation". The IRS reports that estimates of the tax gap as projected from 1987 to 1992 are lower than those that were published in 1983 for tax years 1976 to 1981.

   Has the IRS calculated the growth to reflect the present value of the estimated tax gap?

2. IRS estimates show the individual gap to be declining from $79.3 billion in 1986 to $63.5 billion in 1987. The decline is attributed to tax reform and 1982 Taxpayer Compliance Measurement Program (TCMP) data which showed an improvement in individual voluntary compliance rates. However, after 1987 the amount of the individual tax gap increases again from $64.3 billion in 1988 to $82.6 billion by 1992.

   a. How does the IRS explain the one year decline in the individual tax gap with all years before and after 1987 showing increased individual tax gaps?

b. Does the IRS believe that tax reform and TCMP data will only impact 1987? If so, why?

3. According to the IRS definition, the tax gap consists of unpaid individual and business income taxes on legally earned income. The IRS in its definition of the tax gap excludes illegal source income. The tax gap estimates also do not include gaps resulting from failure to report employment or excise taxes, or any taxes other than the Federal income tax.

a. How much of the reduction in the 1987 tax gap estimates is attributable to the fact that several categories of noncompliance included in the 1983 report were excluded from this year's report?

b. Would it be fair to characterize the 1988 tax gap estimate of $84.9 billion as a starting point rather than a conclusive estimate? Could the tax gap be better characterized as a range, such as $85 billion to $100 billion, rather than the more precise estimate of $84.9 billion?

c. If you included these additional sources of revenue, does the IRS have any idea of how much more should be collected? Would the total tax gap figure be $100 billion or higher?

4. The IRS tax gap study reports that compliance markedly improves when a third party reports to the IRS the amount of income it has paid to individuals. Where there is third party information reporting of wages and salaries; pensions and annuities and interest and dividends the level of tax compliance in these three categories is 99.5%, 98.4%, and 94.6%, respectively.

a. Why have you limited your information reporting to individuals?

b. Is information reporting feasible for corporations? If so, in what areas? If not, why not?

5. IRS reports that voluntary compliance is lower and/or amounts of underreported income are higher in the income categories of: capital gains; sole proprietorships and informal business arrangements; alimony; partnership and small business; and, rents and royalties.

a. Does the IRS plan to expand information reporting on payments to corporations or individuals in any of the above sources of income? If so, in which of the above listed categories?

b. How could information reporting be expanded in each category to reduce the tax gap? Specifically, what should be done in the areas of rent and royalties?

5. In the two highest areas of compliance (i.e., wages and salaries; pensions and annuities) taxes are withheld at the source.

Should we have withholding on additional sources of income? If so, what areas?

7. When the tax laws change, new means of tax avoidance inevitably develop. It sometimes takes both Congress and the Service years to identify new abuses.

a. In what ways can the IRS promptly detect and identify new forms of abuses?

b. Does the IRS have any program to investigate the developing "tax loopholes" which promote tax avoidance?

c. Is it possible to detect noncompliance early on before abuses become too widespread?

8. Because the IRS tax gap definition specifically focuses on taxes not voluntarily paid, all of the amounts IRS collected through various IRS enforcement programs do not reduce the size of the tax gap.

a. If the IRS' definition of tax gap recognized the amounts collected through enforcement programs, what are the estimates of the tax gap for 1987 through 1992?

b. If IRS enforcement programs are considered effective, how does the IRS explain its projections of the individual tax gap growing from $63.5 billion in 1987 to $82.6 billion in 1992?

c. What percentage of the tax gap can be collected from individuals and corporations in an economically feasible manner?

d. In what areas of taxpayer noncompliance will the IRS never be able to improve because enforcement is either too costly or noncompliance is too difficult to deter?

9. The IRS figures on the amount of the tax gap in 1987 provide detailed information on individual noncompliance but very little information on corporate noncompliance. In the case of corporate compliance, the only breakdown provided on small corporations is the amount of unreported income and overstated deductions. In the case of large corporations, an aggregate amount of $15.8 billion dollars is the only information provided in the 1988 tax gap report.

a. The old corporate tax gap estimate for 1986 was $9.7 billion and yet in 1986, the Examination Division proposed almost $11 billion in tax liabilities. How do you explain this?

b. Who are these noncompliant corporations and what types of industries do they represent?

c. Are these corporations "repeat offenders"?

d. How does the IRS propose to deal with repeat offenders?

e. What are these corporations doing that contributes to the tax gap (e.g. not filing returns, overstating deductions, not reporting income)?

f. Which tax law provisions are these corporations abusing?

10. The IRS 1986 Annual Report notes that the Coordinated Examination Program (CEP) includes approximately 1,450 corporations that are examined by the most experienced examiners. In 1986, CEP recommended tax deficiencies and penalties totalling $8 billion. In 1986, all deficiencies proposed by the Examination Division totalled $17.69 billion. In other words, approximately 45% of all deficiencies proposed in 1986 pertained to the 1,450 corporations included in CEP. Further, proposed deficiencies for all corporations in 1986 exceeded $10.8 billion.

a. Which corporations are in CEP? What industry groups do they represent? Why have they been selected for CEP?

b. Can the CEP program be expanded to include more corporations? If so, why hasn't this been done? If not, why not?

c. How much of the IRS' audit resources are devoted to CEP?

d. How many resources (in dollar amounts) would it take to double the amount of corporations in the program? Is such an investment worthwhile?

11. The 1988 study indicates that the Tax Reform Act of 1986 contributed to the projected increases in the business tax gap.

Why wasn't Congress informed by the IRS of this tax reform impact when legislation was thought to be revenue neutral?

12. It has been said that to enhance compliance, the audit rate must be increased. Research indicates that the probability of getting "caught" enhances taxpayer compliance more than the severity of potential sanctions. Others say that its is not the quantity of audits, but rather the quality of the examination that counts. For example, if the IRS examines a return and finds two major errors when in fact the return contains ten, then the poorly conducted audit reinforces taxpayer noncompliance because the taxpayer successfully "hid" from the IRS eight erroneous items.

a. How significant, in terms of enhancing compliance, is the audit rate?

b. Why is the current estimated audit for FY'88 only 1.2% when last year's budget estimated a 1.6% audit rate for FY'88?

c. What audit rate to you plan to have for FY'92 when the tax gap is estimated to be $118.8 billion?

d. Have the quality of examinations improved?

e. What measures have been taken to compensate for the decline in the audit rate?

f. What impact would multiple year audits have on taxpayer noncompliance? Is this a feasible concept?

g. When the IRS proposes a "no change" to a taxpayer's return, should that taxpayer be rewarded? Aside from providing better taxpayer service and prompt refunds, in what other ways can, or should, the IRS reward compliant taxpayers?

13. Recognizing that discussion of the so-called "underground economy" and discussion the IRS' current $50 billion accounts receivable do not fit neatly into analysis of tax gap data, please provide a detailed discussion of each. Include in your response specific information IRS has to better describe the components of the underground economy and the accounts receivable inventory.

Your attention to this matter is greatly appreciated. If any assistance is needed, please contact Vanessa Clark at 225-5522.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/vcw

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Subcommittee on Oversight

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
1105 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

We appreciated the opportunity to testify before your Oversight Subcommittee on the Internal Revenue Service's most recent estimates of the gross income tax gap. As requested in your letter of March 24, 1988, we are providing you with the enclosed responses to the questions that you raised.

I trust this information is responsive to your questions. If you have any questions, please contact Gayle Morin on 566-6070.

With best regards,

Sincerely,

Larry Dish

Question 1.

The 1988 Income Tax Compliance study shows the tax gap has almost tripled since 1973, from $28.4 billion in 1973 to $84.9 billion in 1987, and IRS attributes the growth largely to increased income tax liabilities from "real expansion in the economy and inflation". The IRS reports that estimates of the tax gap as projected from 1987 to 1992 are lower than those that were published in 1983 for tax years 1976 to 1981.

Has the IRS calculated the growth to reflect the present value of the estimated tax gap?

Answer

IRS calculated the growth of the tax gap by relating various components of the gap to projections of relevant economic variables, such as U.S personal income, wages and salaries, interest, or corporate profits. The present value of the estimated tax gap is not a meaningful concept which can be readily calculated in projecting tax gaps because we do not know for how many years the projected tax gaps will persist. Instead, the tax gap estimates are in current dollars which means the tax gap for any specific year is expressed in that year's dollars.

Question 2.

IRS estimates show the individual gap to be declining from $79.3 billion in 1986 to $63.5 billion in 1987. The decline is attributed to tax reform and 1982 Taxpayer Compliance Measurement Program (TCMP) data which showed an improvement in individual voluntary compliance rates. However, after 1987 the amount of the individual tax gap increases again from $64.3 billion in 1988 to $82.6 billion by 1992.

a. How does the IRS explain the one year decline in the individual tax gap with all years before and after 1987 showing increased individual tax gaps?

Answer

The one year decline in the individual tax gap is entirely due to the Tax Reform Act of 1986 that eliminated, restricted, and phased out a number of subtractions from individual income. To the extent that a subtraction from income is no longer allowed, a taxpayer cannot overstate it on the tax return. Moreover, because rates at which individual incomes are taxed were reduced, the tax gap associated with any given amount of unreported income fell. After 1987 the tax gap is projected to grow because taxable incomes grow with continuing inflation and real economic growth.

b. Does the IRS believe that tax reform and TCMP data will only impact 1987? If so, why?

Answer

IRS believes that tax reform will impact 1987 and all years subsequent to 1987 as long as the law remains in effect. We assumed the voluntary reporting percents derived from the 1982 TCMP study will extend beyond 1987 when developing our tax gap estimates. Nonetheless, continuing inflation and economic growth will cause the tax gap to increase.

Question 3.

According to the IRS definition, the tax gap consists of unpaid individual and business income taxes on legally earned income. The IRS in its definition of the tax gap excludes illegal source income. The tax gap estimates also do not include gaps resulting from failure to report employment or excise taxes, or any taxes other than the Federal income tax.

a. How much of the reduction in the 1987 tax gap estimates is attributable to the fact that several categories of noncompliance included in the 1983 report were excluded from this year's report?

Answer

The tax gap presented in the 1983 report did not include the illegal sector. A separate partial estimate for the illegal sector was published in addition to the tax gap estimate for individuals and corporations, which covered only the legal sector. Thus only $7.0 billion of the $30 billion reduction of the 1987 tax gap is due to a single category of noncompliance--i.e., the remittance gap--which was excluded from this year's report due to inadequate data on tax liabilities reported but not paid.

b. Would it be fair to characterize the 1988 tax gap estimate of $84.9 billion as a starting point rather than a conclusive estimate? Could the tax gap be better characterized as a range, such as $85 billion to $100 billion, rather than the more precise estimate of $84.9 billion?

Answer

All tax gap estimates are subject to error. However, the $84.9 billion is our best estimate of the income tax gap that we could measure. We do not believe the income tax gap should be characterized as extending from $85 billion to $100 billion.

c. If you included these additional sources of revenue, does the IRS have any idea of how much more should be collected? Would the total tax gap figure be $100 billion or higher?

Answer

We are now beginning a comprehensive review of our tax gap estimates. The purpose is to identify areas not now covered which could be covered. At present, we cannot tell by how much additional areas will raise the current tax gap.

Question 4.

The IRS tax gap study reports that compliance markedly improves when a third party reports to the IRS the amount of income it has paid to individuals. Where there is third party information reporting of wages and salaries; pensions and annuities and interest and dividends the level of tax compliance in these three categories is 99.5%, 98.4%, and 94.6%, respectively.

a. Why have you limited your information reporting to individuals?

Answer

The information return filing requirements of the Internal Revenue Code mainly apply to payments made to individuals, partnerships, and only to a very limited extent to corporations. The individual return (Form 1040 series) facilitates the matching of information returns because the cash accounting method and calendar year accounting period (used by most individual taxpayers) correspond with the information return reporting and filing requirements. This is not the case with corporations which can have various accounting periods/accounting methods, and may also involve parent-subsidiary reporting and pension profit-sharing plan arrangements.

b. Is information reporting feasible for corporations? If so, in what areas? If not, why not?

Answer

The feasibility of information reporting for corporations is unknown. The Internal Revenue Service is studying the cost effectiveness of a corporate matching program. This study, scheduled to be completed by 1991, will determine the feasibility of using information returns to identify corporate non-filers and the cost benefit of matching information return income to the corporate income tax return of the recipient.

Question 5.

IRS reports that voluntary compliance is lower and/or amounts of underreported income are higher in the income categories of: capital gains; sole proprietorships and informal business arrangements; alimony; partnership and small business; and, rents and royalties.

a. Does the IRS plan to expand information reporting on payments to corporations or individuals in any of the about sources of income. If so, in which of the above listed categories?

Answer

Information reporting is already required for payments made to individuals in the areas of capital gains (e.g., security sales, commodities, and real estate reporting, etc.), non-employee compensation, and rents and royalties. Currently, we do not plan to expand to other types of transactions.

IRS currently has a system to cross check alimony payments/deductions between the ex-spouses.

We are currently looking at a method of associating information return data with partnerships and small business corporations when we conduct an examination of the entity.

Again, as stated above, payments made to corporations are not normally subject to information reporting, but we are looking into the cost/benefit of such a system.

b. How could information reporting be expanded in each category to reduce the tax gap? Specifically, what should be done in the areas of rent and royalties?

Answer

These categories all have a uniqueness not found in other income categories, such as wages or interest income, which could explain why voluntary compliance is lower than other income types reported on information returns. For example, wages and interest are fully taxable as ordinary income. However, the determination of what does or does not constitute alimony is more complex (IRC Section 71) and therefore could cause misreporting. Capital gains require a corresponding determination as to the basis of the asset sold. Rent and royalties (in most cases) and sole proprietorships, informal business arrangements, partnerships, and small businesses are by definition a "trade or business" and are more sophisticated.

Currently most reporting requirements extend from an investment or a trade or business setting. i.e., payments made from or received in a trade or business. To extend this beyond this trade or business concept, such as would be the case of alimony or rent (personal residence) paid by an individual to another individual would be an entirely new concept. Individual taxpayers would then be the payers and would be required to file information returns. Since we feel this would be difficult and burdensome to individuals, we would not recommend expanding information return filing requirements to individuals.

Question 6.

In the two highest areas of compliance (i.e., wages and salaries; pensions and annuities) taxes are withheld at the source.

Should we have withholding on additional sources of income? If so, what areas?

Answer

Withholding at the source has proven to be an effective means of assuring compliance for wages and salaries and also for pensions and annuities. The Congress, of course, has also considered withholding on interest and dividends previously. Although it is likely that compliance could be enhanced by extending withholding at the source to additional types of income, such a change raises broad tax policy issues which would require careful scrutiny.

Question 7.

When the tax laws change, new means of tax avoidance inevitably develop. It sometimes takes both Congress and the Service years to identify new abuses.

a. In what ways can the IRS promptly detect and identify new forms of abuses?

b. Does the IRS have any program to investigate the developing "tax loopholes" which promote tax avoidance?

c. Is it possible to detect noncompliance early on before abuses become too widespread?

Answer

In anticipation of potential problems under the Tax Reform Act (TRA), we are doing several things to identify new methods of tax avoidance.

Compliance Teams in the service centers are screening returns for abusive shelters issues and new issues appearing on tax year 1987 returns. Compliance problems that are identified are communicated to the National Office.

We have identified certain areas where TRA provisions may result in new noncompliance, such as passive loss provisions and the two percent AGI floor on some miscellaneous deductions. We will identify returns meeting specific characteristics, analyze the information on those returns and, when warranted, initiate test programs to ascertain noncompliance and develop supplemental audit selection systems.

In addition, examination classifiers who screen returns will be required to identify issues on returns selected for examination, with particular emphasis on TRA related issues. This information will be forwarded to the National Office for analysis.

Question 8.

Because the IRS tax gap definition specifically focuses on taxes not voluntarily paid, all of the amounts IRS collected through various IRS enforcement programs do not reduce the size of the tax gap.

a. If the IRS' definition of tax gap recognized the amounts collected through enforcement programs, what are the estimates of the tax gap for 1987 through 1992?

Answer

For FY 1987, a preliminary estimate is that over $20 billion in income taxes will be collected through enforcement programs. A more refined estimate for 1987 of the net income tax gap, which is the gross income tax gap less income taxes paid as a result of IRS enforcement activity, is currently being developed for publication in a later report.

b. If IRS enforcement programs are considered effective, how does the IRS explain its projections of the individual tax gap growing from $63.5 billion in 1987 to $82.6 billion in 1992?

Answer

The growth of the individual tax gap from $63.5 billion in 1987 to $82.6 billion in 1992 is due to the growth of individual income tax liabilities through real expansion of the economy and inflation.

c. What percentage of the tax gap can be collected from individuals and corporations in an economically feasible manner?

Answer

The forthcoming report on the net tax gap mentioned above will have an estimate of the percentage of the tax gap that is economically feasible to collect from individuals and corporations.

d. In what areas of taxpayer noncompliance will the IRS never be able to improve because enforcement is either too costly or noncompliance is too difficult to deter?

Answer

The illegal sector by its very nature is a difficult area to improve noncompliance although we will continue to maintain a substantial enforcement presence in this area. It is also difficult to improve compliance in areas where it is easy to hide income, particularly where taxpayers, having informal business styles, keep poor books and records. Nonetheless, improvements are possible in all areas.

Question 9.

The IRS figures on the amount of the tax gap in 1987 provide detailed information on individual noncompliance but very little information on corporate noncompliance. In the case of corporate compliance, the only breakdown provided on small corporations is the amount of unreported income and overstated deductions. In the case of large corporations, an aggregate amount of $15.8 billion dollars is the only information provided in the 1988 tax gap report.

a. The old corporate tax gap estimate for 1986 was $9.7 billion and yet in 1986, the Examination Division proposed almost $11 billion in tax liabilities. How do you explain this?

Answer

The old corporate tax gap estimate for 1986 was understated because it did not adequately take into account the gap associated with unaudited mid-sized corporations and the unreported income of small corporations.

b. Who are these noncompliant corporations and what types of industries do they represent?

Answer

For purposes of tax gap analysis, our statistics divide the corporate sector by asset size--small or large--rather than by industry or other breaks. TCMP data is available by industry for small corporations (with assets less than $10 million). However, no statistics have been compiled on compliance by industry for large corporations.

c. Are these corporations "repeat offenders"?

d. How does the IRS propose to deal with repeat offenders?

Answer

For the purpose of projecting the tax gap, we did not analyze the impact that "repeat offenders" have on the size of the tax gap. However, from an operational perspective, we deal with repeat offenders through multiple year examinations and when appropriate with penalties. When a taxpayer is audited, prior and subsequent year returns are also inspected. If a current year issue is present on other open year returns, the examiner will audit those other years. Depending upon the facts and circumstances of the case, a penalty may be proposed when appropriate.

e. What are these corporations doing that contributes to the tax gap (e.g., not filing returns, overstating deductions, not reporting income)?

f. Which tax law provisions are these corporations abusing?

Answer

It is difficult to generalize about corporate noncompliance because, in the absence of TCMP examinations of corporations with assets of $10 million or more, detailed corporate compliance statistics similar to those for individuals are not available. In particular, data are not readily available for large corporations to distinguish the portion of the corporate tax gap that is due to unreported income from the portion that is due to overstated deductions. However, the internal financial controls established by larger corporations to help protect the interest of their stockholders make it less likely that corporations are underreporting income to IRS. The IRS is currently evaluating the feasibility of a tracking system that would identify and compile the issues we are adjusting on large corporation examinations.

Question 10.

The IRS 1986 Annual Report notes that the Coordinated Examination Program (CEP) includes approximately 1,450 corporations that are examined by the most experienced examiners. In 1986, CEP recommended tax deficiencies and penalties totalling $8 billion. In 1986, all deficiencies proposed by the Examination Division totalled $17.69 billion. In other words, approximately 45% of all deficiencies proposed in 1986 pertained to the 1,450 corporations included in CEP. Further, proposed deficiencies for all corporations in 1986 exceeded $10.8 billion.

a. Which corporations are in CEP? What industry groups do they represent? Why have they been selected for CEP?

Answer

The CEP covers corporate and related individual taxpayers where corporations' size, complexity and diversity of business interests warrant a team approach to the examination process. Consequently, the program does not focus on industries as a criteria. In reality, the taxpayers in the CEP represent all business activities from farming and mining to petroleum, defense contracting, electronics, finance, etc. We do not maintain records on the business types because the conglomorates in the CEP are engaged in many different businesses. The primary categories we monitor in this portion of the CEP are:

1.	Manufacturing	75 percent
2.	Finance, Insurance	13 percent
3.	Transportation, Utilities	10 percent
4.	Wholesale, Retail	2 percent

There are three basic criteria to be met before a case is examined in the CEP:

1. The taxpayers are assigned sufficient points based on a variety of criteria as indicated on the following page.

2. The complexity of the case warrants a team examination approach.

3. There is a high probability that the examination will produce a change to the tax liability.

CEP Criteria

Gross Assets	-	Points are awarded based on broad asset ranges.
Gross Receipts	-	Points are awarded based on gross receipts.
Operating Entities	-	Points are awarded based on the number of major subsidiaries, branches and divisions requiring examination.
Multiple Industry Status	-	Points are awarded for each separate and distinct major industry (e.g., insurance, stock brokerage).
Specialists	-	Points are awarded for each specialist (e.g., International Examiner, Computer Specialist, etc.) required by the case.
Team Members	-	Points are awarded for each agent who is scheduled to devote a considerable amount of time to the case.

b. Can the CEP program be expanded to include more corporations? If so, why hasn't this been done? If not, why not?

Answer

On an annual basis, the district program mangager reviews the cases in the program to assure they continue to qualify and warrant examination by the CEP approach. Since all corporations with $100 million or more assets are manually screened each year, cases newly meeting CEP criteria are identified and added to the program as appropriate. All those

large corporations not included in the CEP program are screened for inclusion in our regular audit program. Because this system accounts for all large corporate returns in this manner, our experience is that it effectively identifies all cases that belong in the CEP.

c. How much of the IRS' audit resources are devoted to CEP?

Answer

In FY 1987, IRS devoted 2,783 revenue agent staff-years to the CEP. In FY 1988 it is planned that this number will increase to 3,471 revenue agent staff-years. This is approximately 19 percent and 21 percent respectively of our revenue agent resources.

d. How many resources (in dollar amounts) would it take to double the amount of corporations in the program? Is such an investment worthwhile?

Answer

We do not feel that adding substantial resources to this program would result in an effective cost/benefit relationship. Our analysis suggests that the current CEP criteria accurately identifies those cases where a CEP would be appropriate. Our own experience suggests that there is little or no marginal dollar return in transferring additional cases into the CEP program.

Question 11.

The 1988 study indicates that the Tax Reform Act of 1986 contributed to the projected increases in the business tax gap.

Why wasn't Congress informed by the IRS of this tax reform impact when legislation was thought to be revenue neutral?

Answer

The projected increase in the size of the corporate tax gap does not affect the revenue neutrality of the Tax Reform Act of 1986. Although tax reform was revenue neutral overall it shifted approximately $120 billion in tax burden from individuals to corporations. In estimating the tax gap for corporations, we assumed that tax reform will have no effect either positively or negatively on the corporate voluntary compliance rate. Accordingly, applying an overage 82.5 percent corporate voluntary compliance rate against an increasing corporate tax base, we arrived at the projected increase in the size of the corporate tax gap.

Question 12.

It has been said that to enhance compliance, the audit rate must be increased. Research indicates that the probability of getting "caught" enhances taxpayer compliance more than the severity of potential sanctions. Others say that it is not the quantity of audits, but rather the quality of the examination that counts. For example, if the IRS examines a return and finds two major errors when in fact the return contains ten, then the poorly conducted audit reinforces taxpayer noncompliance because the taxpayer successfully "hid" from the IRS eight erroneous items.

a. How significant, in terms of enhancing compliance, is the audit rate?

Answer

The audit rate definitely affects taxpayer compliance. To date, however, we have not been able to develop reliable estimates of the effects of enforcement activities on overall tax compliance. Consequently, we have no data currently to indicate what would happen to compliance in response to marginal changes in the audit rate.

b. Why is the current estimated audit for FY '88 only 1.2% when last year's budget estimated a 1.6% audit rate for FY '88?

Answer

Beginning with FY 1987, we received an increase in Examination staffing with the onset of the Multi-Year Revenue Initiative. Although we have overrealized revenue from our initial projections, we have underrealized coverage. The number of examinations in the next few years will not increase as rapidly as initially anticipated for several reasons:

Filed returns continue to grow more complex requiring greater time to examine. In addition, our coverage is much greater in the more difficult, higher income classes.

Our commitment to quality in all our operations means we are taking additional time to do things right.

Our staffing growth involves revenue agents who audit relatively few returns but produce high yields.

The complexity and administration of the TEFRA laws and provisions as they apply to tax shelters results in a steady, but slower closure of these cases than we had originally anticipated. We currently have approximately 300,000 TEFRA Tax Shelter returns in the examination stream. These will close, but not as quickly as we had assumed.

c. What audit rate do you plan to have for FY '92 when the tax gap is estimated to be $118.8 billion?

Answer

Dependent on the level of resources available to the IRS, the coverage would be 1.11 percent if the FY 1989 resources level was the same as FY 1992, and 1.75 percent if a staffing enhancement of 2,500 average positions per year was instituted through FY 1992.

d. Have the quality of examinations improved?

Answer

Examination has initiated numerous quality improvement projects to improve the quality of its audits. These projects involve recruiting, training, and managing. Through the training initiatives we are attempting to hire the best possible candidates. We have revised and expanded our training programs and extended on-the-job training. We have also established a revenue agent and tax auditor coordinator program that involves experienced examiners working with less experienced examiners. This will result in transfer of skills, higher morale and improved work habits.

We are just starting to implement two quality measurement programs. The Line Management Quality Assurance System is a private sector approach to quality. This system provides on line reviews of cases rather than review of cases after they have closed. The Examination Quality Trend Analysis System identifies trends in conformance to our auditing standards. Because we are just beginning to implement these systems, we do not have any measurements on whether our quality has improved. As these systems are implemented we will have quantitative measures on improved quality.

e. What measures have been taken to compensate for the decline in the audit rate?

Answer

In FY 1989, approximately 600,000 additional taxpayers will be contacted in our document matching program to detect underreported income. We estimate the total number of taxpayers who will receive inquiries will be well over 4 million, and the types of issues included in the program have been expanded to include sales of securities and commodities, mortgage interest deductions, and bartering transactions.

f. What impact would multiple year audits have on taxpayer noncompliance? Is this a feasible concept?

Answer

We currently conduct multiple year audits. Not only are multiple year audits conducted but also other related returns of the taxpayer. An example would be a self-employed individual filing a Schedule C and related employment tax, excise tax, and information returns. This individual's Form 1040 audit may cover several years and could also extend to the other related years.

While we do not have any research data to show the compliance affect of multiple year audits, we feel they have a positive impact on compliance.

g. When the IRS proposes a "no change" to a taxpayer's return, should that taxpayer be rewarded? Aside from providing better taxpayer service and prompt refunds, in what other ways can, or should, the IRS reward compliant taxpayers?

Answer

We do not believe that a taxpayer should be rewarded for a "no change" audit because it would only be available to those selected for audit and because it would do little to promote voluntary compliance. It would merely serve as a reward for an inconvenience. In general, we believe that taxpayers who try to comply with the tax laws should be assured that the IRS has effective enforcement programs which will cause noncompliant taxpayers to fulfill their tax obligations.

Question 13.

Recognizing that discussion of the so-called "underground economy" and discussion of the IRS' current $50 billion accounts receivable do not fit neatly into analysis of tax gap data, please provide a detailed discussion of each. Include in your response specific information IRS has to better describe the components of the underground economy and the accounts receivable inventory.

Answer

IRS does not estimate the size of the underground economy. As we explained in our tax gap report, it is not clear what activities are included in this "economy". It usually encompasses both legal and illegal transactions. Illegal activities are very difficult to measure or to tax. Moreover, measuring the tax consequences of illegal activities is paradoxical since IRS would prefer to see these activities stopped than to tax the incomes they generate. For the above-stated reasons, IRS does not estimate the size of the underground economy. However, we do estimate the size of unreported incomes earned in the regular economy, including unreported incomes of informal suppliers such as roadside or sidewalk vendors, moonlighting craftsmen or mechanics, and unlicensed providers of personal care services.

Accounts receivable include items from multiple tax years which arise from enforcement actions taken not only to close part of the income tax gap, but also to enforce the law relating to employment, excise and all other taxes. Much of the accounts receivable occur as a result of taxes that are reported but not paid, in full or in part. As the tax gap report explains, remittance gaps have been excluded from the current IRS tax gap estimates, pending development of more reliable data. Accounts receivable also cover interest and penalty obligations incurred in connection with tax enforcement action.

In discussing how the accounts receivable fit into the analysis of the tax gap it should also be stressed that the tax gap is an annual flow concept analogous to items that would appear on a private company's income statement. In contrast, accounts receivable is a concept analogous to similar items that would appear on a private company's balance sheet. Just as one would not want to add asset values derived from a private company's balance sheet to income measures derived from its income statement, one would not want to add IRS' accounts receivable to its estimate of the tax gap if one seeks to have a meaningful statistic. The income statement of a business is related to its balance sheet. Similarly the tax gap is related to IRS' accounts receivable. However, as the discussion above indicates, the relationship between the tax gap and accounts receivable does not lend itself to mixing the two concepts to measure compliance.

Chairman PICKLE. I commend you again for your emphasis on the taxpayer service. Let us continue that push. The American people, I think, want to comply, and if we can just give them the contact I think they will respond affirmatively.

I thank you very much, Commissioner.

The committee stands adjourned.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

[A submission for the record follows:]

COMMENTS ON THE NEW IRS TAX GAP STUDY

Thomas D. Herman
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Dorgan Task Force Member

In recent years, the "tax gap" has become recognized as a barometer of taxpayer compliance with federal income tax laws. The tax gap consists of the amount of taxes owed that are not voluntarily paid. The recently released IRS report concludes that the tax gap is not as large as previously estimated. The IRS's new estimate of the tax gap for 1987 is $84.9 billion, considerably lower than the old estimate of $115.2 billion. The earlier projection from the IRS's July 1983 tax gap study was revised to reflect recent tax law changes, the availability of more recent compliance data, and improvements in tax gap estimation methods.[1]

Problems with the IRS's Revised Estimates

The Internal Revenue Service's new tax gap study provides valuable information on an issue of vital concern to all Americans. There are several problems, however, with the IRS's new tax gap study. First, roughly one-quarter of the reduction in the tax gap is attributed to legislative changes in tax liability. While the lowering of marginal tax rates and closing of tax loopholes may increase voluntary compliance rates, the bewildering complexity of the new tax rules may partially offset anticipated gains. There is no indication that the complexity of the 1988 filing season was factored into the assumptions of the new tax gap report.

It is widely agreed that this filing season is one of the most difficult in decades. A recent Newsweek cover story focused attention on "The Tax Nightmare" and remarked, "Forget Black Monday. It's Black Friday - April 15 - that could be the real day of financial panic this year." The "tax simplification" act, as the Tax Reform Act of 1986 has been called, resulted in 2,704 changes in the Internal Revenue Code, 42 new regulations, 65 announcements, 32 revenue rulings and 48 new tax forms.[2]

One indication of the complexity of the 1988 filing season is a recent General Accounting Office study that determined that the Internal Revenue Service is giving incorrect answers to 39 percent of the questions posed by people who call for help with their tax returns, compared with 21 percent during the previous filing season. Another indication is that phone calls to the IRS are expected to increase 16 percent over last year. The complexity of the 1988 filing season will undoubtedly result in increased delays, significant additional paperwork, filing mistakes and some level of reduced voluntary compliance. The degree to which the complexity of the filing season will offset anticipated gains in voluntary compliance resulting from legislative changes remains to be seen.[3]

Second, another one-quarter of the reduction in the tax gap is attributed to the puzzling deletion of the so-called "remittance gap" from the revised estimates. The remittance gap refers to the amount of taxes that are reported, but not paid by taxpayers. The 1983 IRS tax gap study included three categories of noncompliance: a) taxpayers who do not file obligatory returns; b) taxpayers who file returns that do not accurately report the tax obligation incurred; and c) taxpayers who fail to pay taxes that are reported as due. The new IRS study omits the latter category entirely.

The IRS provides little justification for omission of the remittance gap: "The remittance gap estimates of the previous IRS report were not sufficiently accurate. Hopefully, we shall succeed in correcting this situation in the near future. In the meantime, however, our revised estimates of the tax gap exclude measures of the remittance gap." Inclusion of the remittance gap in the 1987 calculation would add $7 billion to the tax gap, bringing it to a total of $91.9 billion. By omitting the remittance gap the IRS runs the risk of comparing "apples and oranges" in its 1983 and 1988 tax gap studies.[4]

Finally, as both IRS studies acknowledge, the tax gap estimates are based only on compliance with the individual and corporate income taxes, not with the failure to pay Social Security payroll, excise, or any taxes other than the federal income tax. These other taxes that are omitted from the IRS tax gap study account for approximately 44% of all federal taxes.[5]

There are no overall estimates of the additional "tax gap" attributable to these other sources. While most taxpayer noncompliance occurs in connection with reporting and paying individual and corporate income taxes, there is some indication that noncompliance with other taxes may be significant. For instance, according to IRS estimates, employer noncompliance with Social Security and unemployment taxes has increased sharply in recent years. Employers nationwide currently fail to pay or account for $3.7 billion in payroll taxes, compared with $2.5 billion in 1983.[6]

The Potential for Future Reductions in the Tax Gap

Even if we accept the IRS's revised estimates as correct, the size of the tax gap remains unacceptably large and growing. While the new IRS study calculates that the overall income tax gap declined from $95 billion in 1986 to $84.9 billion in 1987, the study projects that the tax gap will increase each year thereafter reaching $113.7 billion in 1992.

Furthermore, even the IRS admits that voluntary compliance did not improve among all types of taxpayers. According to the new IRS study, the corporate voluntary compliance rate dropped almost 5 percent during the 1980's. Under the previous IRS study, the corporate voluntary compliance rate was estimated to be 87.5% in 1979 and 86.4% in 1981. Under the new IRS study, the corporate voluntary compliance rate is estimated to average 82.5% between 1988 and 1992.[7]

While the new IRS study estimates that the individual income tax gap declined between 1986 and 1987, it estimates that the corporate income

tax gap actually increased from $15.6 billion in 1986 to $21.4 billion in 1987. Similarly, the corporate income share of the tax gap increased from 16.4% in 1986 to 25.2% in 1987. The corporate income share of the tax gap is expected to continue to increase, reaching 27.4% in 1992.

Unfortunately, the potential for future reductions in the income tax gap can't be determined from the IRS's new tax gap study. The new study bases its revised estimates of the tax gap on four factors: legislative changes in tax liability; new data; improved methodology; and omission of the remittance gap. The new estimates are not based upon any needed improvements in IRS enforcement against delinquents and evaders, on better service for honest taxpayers or on any discernable up-tick in old-fashioned taxpayer honesty or volunteerism. The IRS study makes no effort to measure the potential for further reductions in the tax gap if substantial changes are made in the IRS's operations and resources.

A valuable analysis for determining how much the tax gap could be reduced if tax enforcement were strengthened and taxpayer assistance improved is provided by the 1987 report of the Dorgan Task Force. The bi-partisan "Tax Gap Task Force", was convened by Congressman Byron L. Dorgan (D-ND), and co-chaired by former IRS Commissioners Donald C. Alexander (1973 to 1977) and Jerome Kurtz (1977 to 1980).

After a thorough examination of IRS operations and resources, the Dorgan Task Force concluded that additional expenditures of $3.6 billion on tax administration over a five-year period could raise $105 billion in additional tax revenues during the same period, and $35 billion a year thereafter. The Dorgan Task Force recommended that the IRS increase its personnel in the areas of examinations, appeals, investigation, collection and taxpayer service by 32,487 over the five-year period (FY 1988 - FY 1992). The Task Force concluded that with these additional resources the IRS could raise its audit rate from the 1986 level of 1.13% of all returns processed to the 1976 level of 2.5% of all returns.[8]

While the Dorgan Task Force's report received considerable attention after its release in May 1987, few of its recommendations for expanding the IRS's enforcement forces and improving the IRS's taxpayer assistance programs have been adopted. In fiscal years 1988 and 1989, the Reagan administration added, or plans to add, only 21.8% of the additional employees recommended by the Dorgan Task Force in the areas of examinations, appeals, investigation, collection, and taxpayer service.[9]

If the entire five-year projections for fiscal years 1988 - 1992 are considered, the Reagan administration, to date, has added, or has current plans to add only 9.3% of the additional personnel recommended by the Dorgan Task Force. In other words, over 90% of the Dorgan Task Force's personnel recommendations remain to be implemented in FY 1990 and beyond. Significant progress in narrowing the tax gap is still possible if the major Dorgan Task Force's recommendations are adopted by Congress including: hiring more tax examiners to raise the audit rate back up to the 2.5% overall level of the mid 1970's; providing more extensive taxpayer assistance; upgrading telephone service; expediting appeals and litigation; increasing efforts to collect accounts receivable; and expanding efforts to collect taxes on overseas income.[10]

The continued decline in the IRS's audit coverage rate is another indication that the Dorgan Task Force's recommendations are still achievable, despite any decline in the tax gap, if substantial changes are made in the IRS operations and resources. In 1987, the IRS audit coverage rate was 1.10% of all returns processed, a decline from the 1986 rate of 1.13%. This coverage rate includes individual income, corporate income, estate and gift tax returns. While the individual income audit rate dropped marginally from 1.10% in 1986 to 1.09% in 1987, the corporate income audit rate dropped precipitously from 2.25% in 1986 to 1.58% in 1987. Since 1976, the individual income audit rate has dropped by more than one-half (from 2.25%), and the corporate income audit rate has dropped by more than four-fifths (from 9.5%).[11]

A study conducted by California Institute of Technology economists Jeffrey Dubin and Louis Wilde and Yale law professor Michael Graetz is even more optimistic than the Dorgan Task Force on the potential benefits to be derived from raising the audit rate to the level that prevailed in the mid 1970's. The Dubin-Wilde-Graetz study, released in May 1987, estimated that total IRS collections would have risen by $47.43 billion in 1985 had the audit rate remained at its 1977 level. The authors attributed most of this potential reduction in the tax gap to the general deterrence effects of the increase in audit rates, not just to large increases in additional taxes and penalties collected directly through the additional audits.[12]

Conclusion

While progress may already have been made in improving voluntary compliance through tax law changes, we still need a reform of tax administration as comprehensive as the reform of the federal tax code in 1986. The problem is critical and touches the lives of every American. With the federal deficit as large as it is, the size of the tax gap is not only fiscally indefensible, but unfair to the vast majority of Americans who pay their taxes on time and in full.

What is needed to reduce the tax gap is a program of increased taxpayer service and aggressive enforcement against delinquents and evaders. This program could be based upon the successful experiences of states across the nation - states like North Dakota, which under Byron Dorgan and Kent Conrad, has been a pioneer. And like Massachusetts, where an innovative and aggressive approach has turned the tide and reversed the trend of tax evasion in Massachusetts.

In Massachusetts, for example, tougher enforcement directly yielded $1.3 billion in new revenues over the period FY1984 - FY1987, while improved voluntary compliance indirectly yielded another $1.7 billion. At the same time, honest taxpayers have been treated as valued customers, not as victims of an uncaring bureaucracy. Among the steps Massachusetts has taken to improve taxpayer service are: simplifying and rewriting tax forms so that people can understand them; substantially increasing the number of available taxpayer assistance personnel; and getting refunds out in two weeks, when it used to take months.[13]

Massachusetts has also worked on changing public attitudes about tax evasion, in much the same way as the state has sought to change attitudes toward drunken driving: by helping people to understand that tax evasion

isn't a victimless crime; that the enemy is not the tax collector but the tax evader. All this has helped to restore public confidence in government, and has helped to provide enough additional revenues to give Massachusetts citizens the largest tax cut in our state's history.

The IRS is a competent, honest agency which needs our support. What is required is a commitment to a balanced strategy -- one articulated by the Dorgan Task Force -- of quality taxpayer service, toughened enforcement and changed public attitudes to ensure that no American pays more than his or her share. This approach has worked in Massachusetts and in many states across the country. And it will work federally. Let's put the "service" back in the Internal Revenue Service. Let's put tax delinquents on notice that audit lottery is no longer a winning game. This is not a partisan issue. This is not an academic issue. It's an issue of fiscal responsibility. And it's an issue of fairness to the American taxpayer who's been subsidizing evaders for too long.

Footnotes

1. Internal Revenue Service, Income Tax Compliance Research: Estimates for 1973-1981, July 1983, Washington, D.C.

2. "The Tax Nightmare", Newsweek, February 29, 1988;

3. Robert Pear, "Errors Found in a Third of Replies by I.R.S. to Phoned Tax Questions", The New York Times, February 23, 1988, p. 1.

4. Internal Revenue Service, Income Tax Compliance Research: Gross Tax Gap Estimates and Projections for 1973-1992,Publication 7285 (March, 1988), Washington D.C., p. 11. The remaining half of the reduction in the tax gap is attributed to new and improved data. This category is difficult to analyze without more information on the assumptions underlying these changes. The IRS will be releasing a more detailed study on these assumptions in the near future.

5. Office of Management and Budget, Budget of the United States Government: Fiscal Year 1989, p. 1-2.

6. George Guttman, "IRS To Expand Employment Tax Withholding Compliance Initiative," Tax Notes, March 7, 1988, p. 1026. (Note: The tax gap estimates are for legal source income only. The new IRS tax gap study does not include an estimate for the illegal sector tax gap, as did the 1983 IRS study.)

7. For the corporate voluntary compliance rate under the previous IRS study see: Internal Revenue Service, Income Tax Compliance Research: Estimates for 1973-1981, July 1983, Appendix I.

8. The Report of the Dorgan Task Force on Narrowing the $100 Billion Tax Gap, May 4, 1987. (Personnel figures refer to the number of full-time equivalent employees.)

9. The Dorgan Task Force's recommendations called for additional IRS examiners, above and beyond the FY 1987 expansion. In fiscal year 1988, the Dorgan Task Force recommended 2,837 additional positions in examination, while the Reagan administration added only 1,082. In fiscal

year 1989, the Dorgan Task Force recommended 3,000 additional positions in examination, while the Reagan administration plans to add only 443. Thus, the Reagan administration has added or plans to add only 26.1% of the examination positions recommended by the Dorgan Task Force in fiscal years 1988 and 1989.

More importantly, the Dorgan Task Force expected additional revenues to be raised, not just by increases in IRS examiners, but by increases in other crucial operational areas as well. The Reagan administration has fallen far short of the Dorgan Task Force's recommendations in each of these other areas. In fiscal years 1988 and 1989, the Reagan administration has added or plans to add 0% of the recommended appeals and tax litigation personnel; 6.6% of the recommended overseas enforcement employees; 20.6% of the recommended tax fraud investigation personnel; 0% of the recommended collection employees; and 36.1% of the recommended taxpayer service personnel. (These recommendations called for additional IRS personnel above and beyond the Reagan administration's initial fiscal year 1988 budget estimates.)

Thus, in fiscal years 1988 and 1989, the Reagan administration added, or plans to add, only 3,110 of the additional 14,262 employees recommended by the Dorgan Task Force in the areas of examinations, appeals, investigation, collection, and taxpayer service. [See the charts in Appendices I - IV.]

10. One qualification is in order. The Dorgan Task Force based its $105 billion estimate on a one percent increase per year in the voluntary compliance rate (FY 1988-FY 1992). Under the new IRS study, however, the amount of additional revenue that can be raised over the five year period by a one percent increase in the voluntary compliance rate is $89 billion. Each year, a one percent increase brings in the following additional revenue: 1988 ($5.31 billion); 1989 ($5.73 billion); 1990 ($6.22 billion); 1991 ($6.73 billion); and 1992 ($7.20 billion). When these amounts are added up cumulatively, they total $88.8 billion over the five year period. This change arises not because of any increase in the voluntary compliance rate, but because of a decrease in the estimates of total taxes owed each year.

11. The Internal Revenue Service, 1976 Annual Report, Table 2; The Internal Revenue Service, 1986 Annual Report, Table 7; the forthcoming Internal Revenue Service, 1987 Annual Report, Table 7; See also "The Quantity and Quality of IRS Audits: Experts Agree Both Must Improve", Tax Notes, April 11, 1988.

12. Jeffrey A. Dubin, Michael J. Graetz, and Louis L. Wilde, "Penny-Wise and Pound-Foolish: New Estimates of the Impact of Audits on Revenue", Tax Notes, May 25, 1987.

13. "Improving Voluntary Compliance with Tax Laws: The Massachusetts Experience," Massachusetts Economic Indicators, Volume II, Number 10, October 1987.

APPENDIX I

Dorgan Task Force Recommendations
Examination and Appeals
Full-Time Equivalent Employees

	Recommended Increase FY 1988*	Recommended Increase Each Year FY 1989 - 1992	Total Recommended Increase FY 1988 - 1989	Total Recommended Increase FY 1988 - 1992	Percent of Recommendations Adopted FY 1988 - 1989	Percent of Recommendations Adopted FY 1988 - 1992
1. Examination	2,837	3,000	5,837	14,837	26.1%	10.3%
2. Appeals and tax litigation	—	600	600	2,400	0.0%	0.0%
3. Employee plans and exempt organizations	—	—	—	—	—	—
4. International	600	250	850	1,600	6.6%	3.5%
Total	3,437	3,850	7,287	18,837	22.0%	8.5%

*The FY 1988 change is measured by the difference between the FY 1988 authorized level and the FY 1988 budget estimate (the Dorgan Task Force's baseline). For the examination category, however, the FY 1988 change is measured by the difference between the FY 1988 authorized level and the FY 1987 authorized level (the Dorgan Task Force's baseline in this one instance).

Source: Report of the Dorgan Task Force on Narrowing the $100 Billion Tax Gap, issued May 4, 1987.

APPENDIX II

IRS Budget Estimates
Examination and Appeals
Full-Time Equivalent Employees

						Increase or Decrease (-)		
	Appropriation FY 1986	Authorized Level FY 1987	Budget Estimate FY 1988	Authorized Level FY 1988	Budget Estimate FY 1989	Change FY 1988*	Change FY 1989	Total Change FY 1988 - 1989
1. Examination	28,656	31,893	34,730	32,975	33,418	1,082	443	1,525
2. Appeals and tax litigation	3,586	4,578	5,295	5,277	5,279	(18)	2	(16)
3. Employee plans and exempt organizations	2,377	2,504	2,885	2,903	2,925	18	22	40
4. International	—	724	734	737	790	3	53	56
Total	34,619	39,699	43,644	41,892	42,412	1,085	520	1,605

*The FY 1988 change is measured by the difference between the FY 1988 authorized level and the FY 1988 budget estimate (the Dorgan Task Force's baseline). For the examination category, however, the FY 1988 change is measured by the difference between the FY 1988 authorized level and the FY 1987 authorized level (the Dorgan Task Force's baseline in this one instance).

Source: Internal Revenue Service, Budget Estimates, Fiscal Years 1988 and 1989.

APPENDIX III

Dorgan Task Force Recommendations
Investigation, Collection and Taxpayer Service
Full-Time Equivalent Employees

	Recommended Increase FY 1988*	Recommended Increase Each Year FY 1989 - 1992	Total Recommended Increase FY 1988 - 1989	Total Recommended Increase FY 1988 - 1992	Percent of Recommendations Adopted FY 1988 - 1989	Percent of Recommendations Adopted FY 1988 - 1992
1. Tax fraud investigations	250	250	500	1,250	20.6%	8.2%
2. Collection	1,200	1,200	2,400	6,000	0.0%	0.0%
3. Taxpayer service	3,300	775	4,075	6,400	36.1%	23.0%
4. Enforcement litigation and technical	—	—	—	—	—	—
Total	4,750	2,225	6,975	13,650	21.6%	11.0%

*The FY 1988 change is measured by the difference between the FY 1988 authorized level and the FY 1988 budget estimate (the Dorgan Task Force's baseline).

Source: Report of the Dorgan Task Force on Narrowing the $100 Billion Tax Gap, issued May 4, 1987.

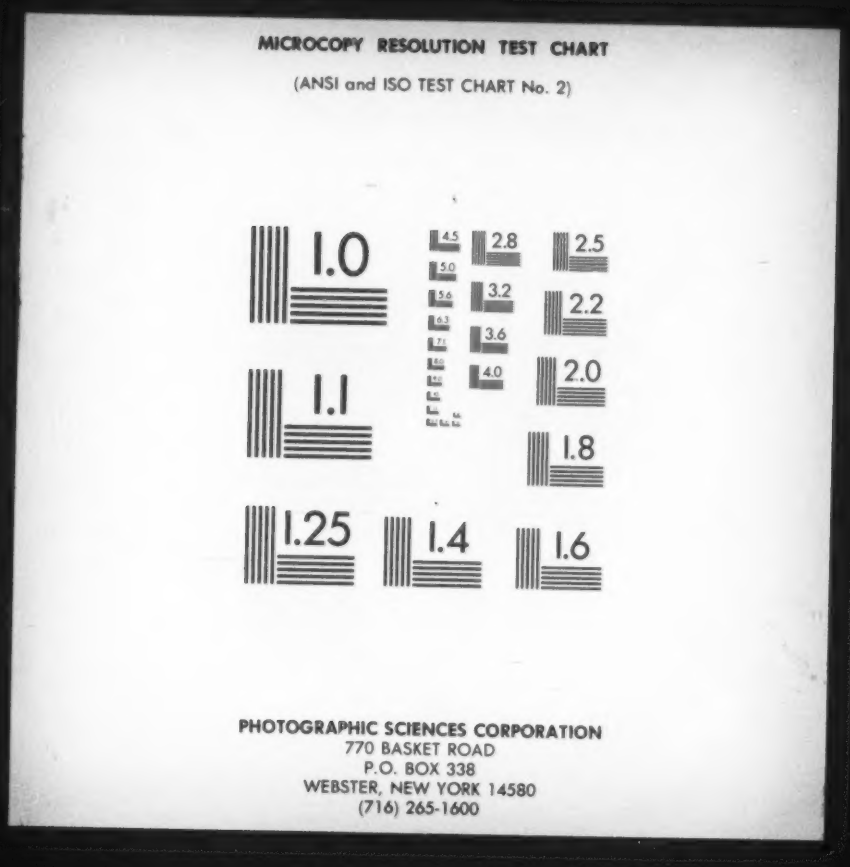
APPENDIX IV

IRS Budget Estimates
Investigation, Collection and Taxpayer Service
Full-Time Equivalent Employees

						Increase or Decrease (-)		
	Appropriation FY 1986	Authorized Level FY 1987	Budget Estimate FY 1988	Authorized Level FY 1988	Budget Estimate FY 1989	Change FY 1988	Change FY 1989	Total Change FY 1988 - 1989
1. Tax fraud investigations	4,446	4,488	4,517	4,516	4,620	(1)	104	103
2. Collection	17,147	17,710	20,438	20,334	20,379	(104)	45	(59)
3. Taxpayer service	5,696	5,395	5,704	7,206	7,174	1,502	(32)	1,470
4. Enforcement litigation and technical	1,350	1,382	1,430	1,425	1,421	(5)	(4)	(9)
Total	28,639	28,975	32,089	33,481	33,594	1,392	113	1,505

"The FY 1988 change is measured by the difference between the FY 1988 authorized level and the FY 1988 budget estimate (the Dorgan Task Force's baseline).

Source: Internal Revenue Service, Budget Estimates, Fiscal Years 1988 and 1989.



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